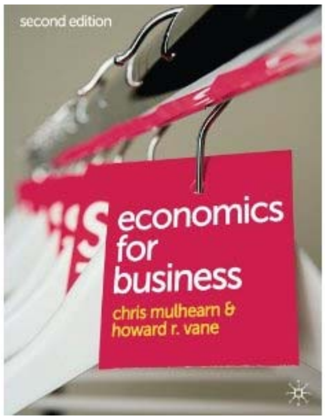
BUSINESS CASE STUDY: GREECE AND THE EURO CRISIS



Were they to have their time over again would the Greek people and politicians choose as they did in 2001 to give up their ancient currency, the drachma, in favour of the then barely two-year-old euro? We guess not. So why are Greek politicians now scrambling to keep Greece ***in*** the euro area when very many ordinary Greeks want out? And why should non-euro area economies care at all what happens – to borrow a not altogether inapposite phrase – in far away countries of which they know little?

It's a complex picture. Let's start with the original reasons for Greek membership of the euro area.

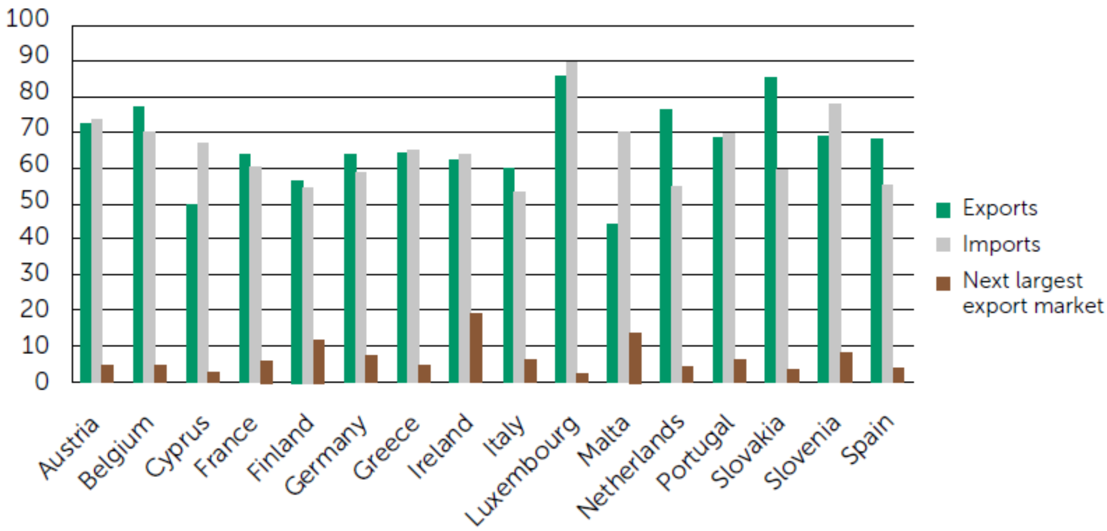


Figure 14.14 Euro area members share of trade with EU 27, 2008 (per cent)
Source: Data from the World Economic Outlook database, courtesy of IMF

The figure above from chapter 14 of the textbook shows why the Greeks thought euro area membership was a good idea. More than 60 per cent of Greek exports and imports are with other EU economies, most of which use the euro. As Greece too uses the euro it gets **price transparency** in trading most of its goods and services and the **exchange rate risk** on that trade is eliminated entirely. Why are these developments positive?

Imagine a Greek firm that wants to expand its output. It needs new machinery that's made in Germany. Because the contract for the purchase and maintenance of the machinery will be in euros, the Greek firm does not have to worry that adverse currency movements will wreck its business plan. If Greece still had the drachma and the drachma weakened, the firm might have to pay a lot more drachmas to get the euros it needed. So there is **no exchange rate risk** on this investment when Greece is in the euro area.

Once the machinery is installed and the new products begin to flow, the firm has the task of selling the extra output. Some of it might find buyers in Athens or Thessalonica. Fine; the customers there can understand the firm's prices whether Greece is in the euro area or not as they and the firm use the same currency. But what about customers in Finland, Ireland and the other euro countries? Because the Greeks use the euro our firm can more easily sell its output in this very large and lucrative market as **Greek prices are transparent** throughout the euro area. As indeed are all other members' prices. Such transparency is good for Greece as all of its manufacturers, hoteliers, tour operators, shipping agents, cheesemakers, insurance companies and banks have the opportunity to do business as simply as possible in the euro area. If they're good at what they do the Greek economy grows and Greek living standards rise.

We can briefly run this argument the other way. Think of whether the city, town or village where you live would be better off with its own *unique* currency. Want to buy a phone in the next town and a coffee in the one beyond that? Need to buy petrol on the way home? You'd need possibly three other currencies. And did you pay a fair price in each case? Maybe; you'd need to think through three different exchange rates to be sure. And if you make the same trip next week, in all likelihood currency movements will have altered the prices you've just worked out. Just having one currency begins to look like a good idea.

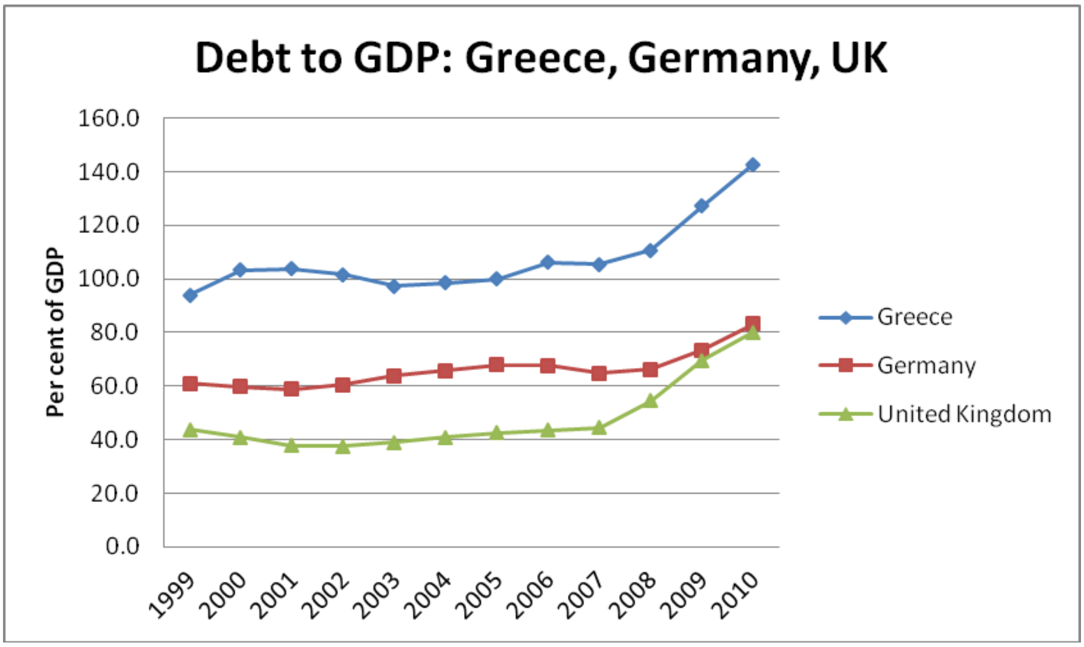
So, the Greeks joined the euro area because it seemed, economically, like a good idea at the time. What's gone so badly wrong?

Well, at first, nothing.

The figure above shows that compared to Europe's economic powerhouse, Germany, the Greek economy expanded at a favourable rate both before and after it joined the euro area. How did Greece manage this? Amongst the factors working in its favour were additional demand from extra government spending on the 2004 Olympics and more borrowing and spending by Greek citizens as a result of the euro area's low interest rates. And working away in the background was the potential of rising demand from the euro-dominated single market.

At this time few economists took much notice of Greece as a source of instability inside the euro area. The standard worry was Italy. Greece looked too small to be a problem as it accounted for less than 4 per cent of euro area GDP.

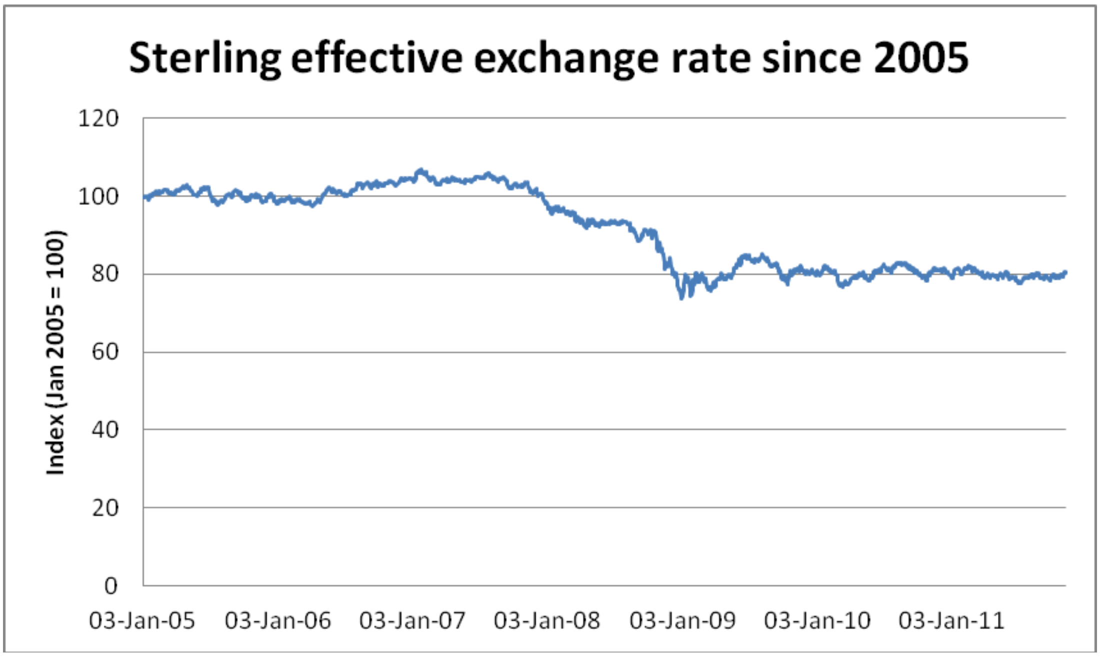
It was the world financial crisis that began to reveal the precarious states of several euro area economies – in particular Ireland, Portugal and Greece. The financial crisis showed that many institutions all over the world had taken on excessive risk in the good times up to 2007. Banks and other financial institutions had done this but so too had governments. More debt is not necessarily a problem. Individuals borrow to finance consumption or house purchase, firms borrow to invest and governments borrow to do both. What counts is the ability to service and repay debt.



And this is the problem for Greece. The figure above shows what has happened to the overall debt levels of Greece, Germany and the UK. Although debt in Germany and the UK has increased, it has reached 'only' about 80 per cent of national income. For Greece the figure is over 140 per cent. A debt burden on this scale is an issue not just because it looks so big in relation to the national income stream which has got to finance and eventually repay it. The additional difficulty is what is happening to Greece's national income stream. It's shrinking. Greek GDP is expected to *fall* by about 5 per cent in 2011. This makes the Greek debt picture appear unmanageable.

And things get worse when we think about how governments borrow. They do it continually, rolling over chunks of debt at a time. As a debt of billions falls due, another loan is taken out to pay it off. This is how we know that the Greek state is bankrupt. When it was trying to roll over debt during the financial crisis the markets would lend to it only at prohibitively high interest rates – so high that the Greek government could not afford to pay. It was at this point that other euro area governments stepped in to help, drawing on a new European Financial Stability Facility (EFSF) of €440bn. This is now being used a second time to keep the Greek state from defaulting on its debt. Greece's banking creditors have also agreed a 50 per cent 'haircut' on what they are owed to try to prevent Greece simply defaulting on everything.

We know that the explosion in Greek debt is a problem, but how exactly does it relate to Greece's euro area membership? We can answer this question by looking back and looking forward. Looking back, euro area membership gave the Greek state some credibility with the markets so that its high level of debt did not look too bad and it was able to borrow to both service the debt and spend money in the economy. But it is only by looking forward that we can begin to understand the real difficulties that Greece faces.



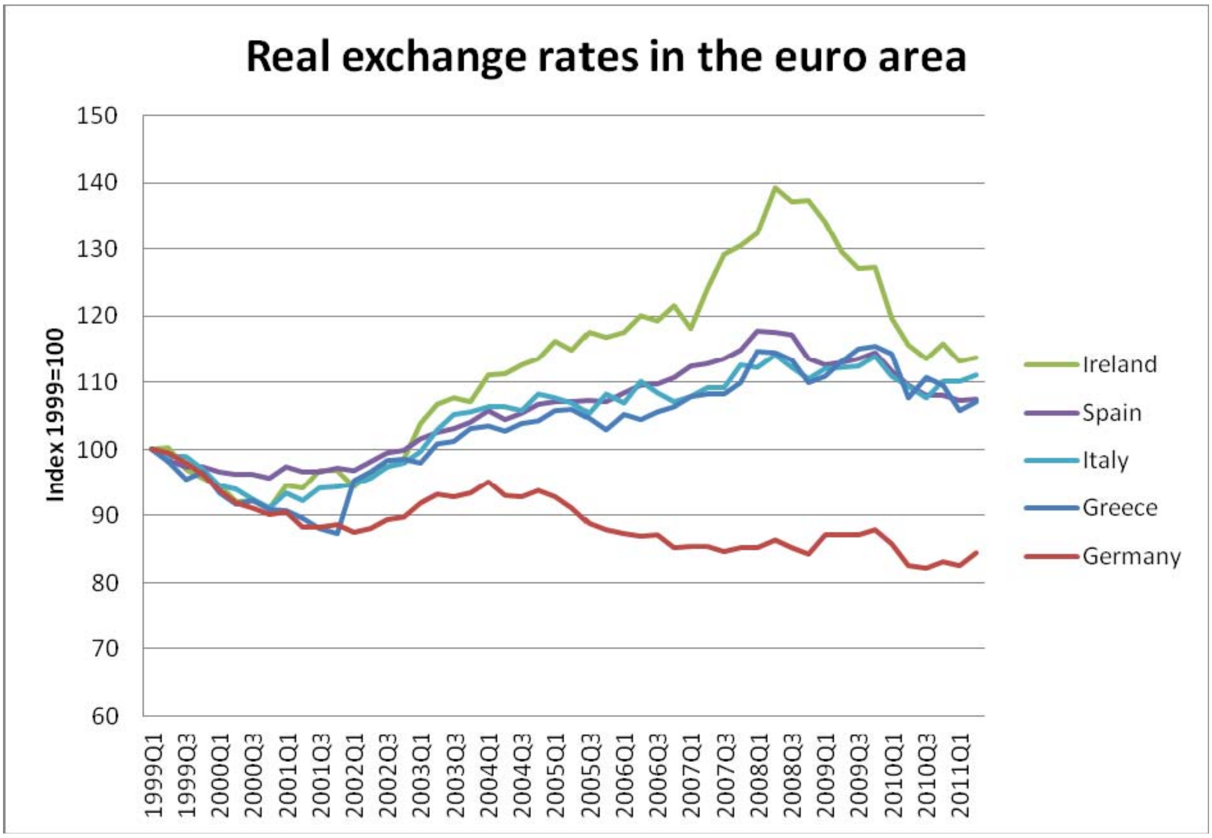
When a country joins the euro area the payoff is growth-boosting price transparency and the elimination of exchange rate risk with other euro area members. But there is a cost. A euro area member ***loses monetary independence***. Its nominal exchange rate is permanently fixed in relation to its new partners and its interest rate is set by the European Central Bank (ECB). Think about the potential importance of a country's exchange rate when times are hard. As the figure above shows, the effective exchange rate of the pound has fallen by about 20 per cent over the past couple of years meaning that the pound now buys fewer US dollars, Japanese yen, euros and other currencies than it did before. This is actually a really helpful development as it reduces the price of UK exports and increases the price of UK imports. The British government anticipates that this will provide a stimulus to growth. At the same time, because UK interest rates are under the control of the UK authorities, they may be set so as to promote British macroeconomic priorities.

For Greece and other euro area members in difficulty these levers of macroeconomic policy are no longer available. Greece can never again see its currency depreciate against the currencies of its main trading partners – a euro in Athens is the same as a euro in Berlin or Paris. Nor can the Greek authorities implement a helpful regime of low interest rates. Indeed the ECB actually *raised* rates in 2011 because of concerns about the level of euro area inflation.

So what can Greece actually do to engineer the economic growth that it desperately needs? In macroeconomic terms it can do virtually nothing that will have a positive effect in the short-to-medium term. Monetary policy has been surrendered and fiscal policy is heavily constrained by its debt. This leaves open only a *microeconomic* policy response.

Indeed in the euro area it is microeconomic policy that is intended to take the strain when economies falter. Notice in the UK case that the *nominal* value of the pound has fallen – this means that, for example, the pound is now worth $1.60 rather than $2.00. This is not the same as the *real* value of the pound. The real value of a currency is not what it buys in terms of other currencies but what it buys in terms of the goods of other countries. For Greece this offers a way forward. Should Greek workers improve their productivity and agree to zero wage increases then over time Greek goods will become more competitive in the euro area meaning that Greece's ***real exchange rate*** will have fallen. As a consequence, the rest of the euro area's demand for Greek goods should improve, pulling Greece out of the doldrums.

Unfortunately, as the figure below shows, the signs of this happening in Greece or some of the other crisis-hit euro countries are not really evident. In fact it is in Germany that the real exchange rate has fallen most markedly since 1999. German labour markets have become more competitive relative to those elsewhere making the euro area crisis appear all the more intractable. The micro-level responses that were supposed to help the weaker economies are for the moment doing the reverse.



Which brings us back to the questions we started with – why are Greek politicians striving to keep Greece in the euro area? Why are Italian politicians hoping they succeed? And, finally, why should non-euro area countries care about any of this?

For Greek politicians it's a matter of choosing the 'least worst' option. Staying in means continued austerity as the debt is reduced and – hopefully – the labour market delivers a lower real exchange rate. Politically this will be hard to manage in the face of widespread popular discontent. The alternative is the return of the drachma and a huge and immensely destabilizing flight of capital out of the country. At a rough guess anyone re-pricing their wealth or incomes in new drachmas will see a loss of about 50 per cent. What then happens to the EFSF aid to Greece becomes an open question. Will euro area members continue to help a former member? Probably not.

For Italy the concern is that if Greece should leave the euro area the markets will suspect that Italy may follow, pushing up interest rates on Italian debt to unsustainable levels. So the Greek pain spreads to Italy.

For other euro area members and non-members an Italian crisis matters because of the size of the Italian economy. Italy accounts for about 18 per cent of the euro area. An Italian default would hit the world's financial institutions *very* hard. The nadir of the credit crunch was heralded by the collapse of Lehman Brothers once valued at more than half a trillion dollars. Italy’s GDP is roughly four times that amount. And if Italy why not Spain and then Portugal? Contagion across the euro area is a real threat. This is why the present crisis is potentially more serious than the credit crunch and why everyone – inside the euro area or not – cares about it.