Greek Crisis: Back to Basics

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The willingness to distribute pain between both debtors and creditors is the only sensible way forward for the fragile currency bloc.

Greece has been in the headlines for quite some time now. Much ink has been spilled about the ongoing saga of debt relief negotiations and whether or not the Eurozone's austerity demands imposed on Greece are appropriate or too harsh.

From an analytical standpoint, while Greece is undoubtedly to be blamed for the current mess in which, it and the entire Eurozone region is stuck, creditor countries like Germany are also culpable. After all, the Greek crisis lay in massive external imbalances in the form of huge current account deficits financed by capital flows from the Eurozone core countries like France, Germany, and Italy. These three core countries together held half of Greek debt securities at the end of 2008, and Western Europe as a whole owned around 80 per cent of Greek's massive debt (which stood at around US$160 billion then). As the country inches closer to receiving a third bailout package from the Troika (consisting of the IMF, ECB and the European Commission), it is imperative to recognise that the burden of adjustment cannot fall on Greece alone.

To illustrate this point better, let us go back to the basic balance of payments tenet. The balance of payments of a country must always balance, implying that the sum of current account balance (CAB) and the capital/financial account balance (KAB) must be equal to zero. While the CAB is a mirror image of the KAB, CAB of a country is nothing but a reflection of the difference between a country's national savings and investment.

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If a country is running large current account deficits (CAD) then it must imply that national investments far exceed national savings. A growing CAD can either be driven largely because of rising national investments or, as was the case in Greece, declining national savings.

One of the problems with the popular narrative of Greece's fiscal profligacy is that it assumes that countries typically running CADs need to attract more capital inflows (foreign savings) to finance the gap. However, the balance of payments says nothing about causation. One can well argue that massive capital inflows into countries with CADs allows them to borrow at fairly low rates which, in turn, could fuel an unsustainable domestic consumption boom. In fact, this is what happened in Greece.

Though Greece ran fiscal deficits, mainly on account of rising expenditures on social transfers and public sector wages, there was a twist in the tale once it joined the Eurozone (in 2001). Greece's post-Eurozone entry saw a significant widening of the country's CAD (which more than doubled from about 7 per cent in 2001 to whopping 15 per cent in 2008). This coincided with a rather dramatic improvement in the external balance of Eurozone core countries like Germany (from a balanced current account to about a 7 per cent CAS during the same period). The CAS in Germany in turn contributed to a significant movement of capital from Germany to Greece (and also from other Eurozone core countries to the periphery more broadly). These capital flows fueled a massive and unsustainable consumption boom in Greece while worsening the country's export competitiveness.

When private capital flows came to a sudden stop during the global financial crisis, Greece was left to grapple with a huge net external debt—around 85 per cent of its GDP as of 2009Q4 before its debt was downgraded, eventually leading to its first bailout package in April 2010—and a severe loss of competitiveness. The subsequent retardation of the economy has resulted in the ballooning of Greece's net external debt to 140 per cent of GDP as of 2015Q1.

Now, if Greece still had its own currency, perhaps it could have regained its competitiveness by engineering currency devaluation along with a partial debt default *a la* Iceland. Given the lack of such an option in a regional currency area, the adjustment has had to come from within Greece, especially when Germany has been reluctant to share the burden via greater domestic spending to facilitate the Eurozone's recovery from the deep recession.

Indeed, all the burden of adjustment so far has fallen on Greece. Its economic output has shrunk by a massive 25 per cent relative to 2009, largely because of the strict austerity measures imposed in return for the earlier (two) bailout packages. Greece has been forced to undertake more belt-tightening policies by raising taxes and the retirement age as part of the third bailout deal (€86 billion) being negotiated. Above all, the country has to achieve a 3.5 per cent primary budget surplus by 2018 up from 1 per cent in 2015, which is a herculean task.

While continued consolidation on the part of the Greeks appears important to avoid moral hazard problems in the future, creditor countries must also accept some of the adjustment costs. This entails a combination of at least two things: The first involves forgiving a larger part of the debt owed to them by Greece. The second requires undertaking more expansionary fiscal policies that will help facilitate growth in Greece and rest of the Eurozone. Such policies will also help reduce Germany's large and growing current account surpluses. The willingness to distribute pain between both debtors and creditors is the only sensible way forward for the fragile currency bloc.