Greece: An ending in sight?

As the latest talks between Greece's cash-strapped government and its international creditors collapse, Manulife Asset Management's Chief Economist, Megan Greene, assesses the chances of a deal being struck and the implications for Greece and the eurozone.

The good news is that an endgame for Greece is nigh, and the best case scenario for Greece and the eurozone is still the most likely outcome. The bad news is that the best case scenario for Greece is still a highly unpalatable one. Even if Greek Prime Minister Alexi Tsipras agrees to whatever demands Greece's creditors make to avoid default and manages to hold his party and government together, Greece faces an extremely tough road ahead towards potential sustainable growth.

A deal is likely

Last week policymakers were full of warnings for Greece that time is running out to agree a deal and secure liquidity. As European Council President Donald Tusk said[1], "The day is coming, I am afraid, that someone says the game is over."

That day is not as close as most seem to think. There have been calls for Greece to sign on the dotted line by the next eurogroup meeting on 18 June. That is an artificial deadline, and will likely pass as all other artificial deadlines have – without a deal. The real deadline is when Greece runs out of cash. Given that the Greek government has chosen to bundle its International Monetary Fund (IMF) loans to repay them at the end of the month and Greece's bailout program ends on 30 June, a deal must be agreed and ratified in various parliaments by then. I don't think anyone should expect an agreement much before then.

There are two reasons to be optimistic a deal will be found. First, according to the latest Metron Analysis poll on 3-4 June, around 80% of Greeks want to remain in the eurozone[2]. This Greek government has absolutely no mandate to lead Greece to a Grexit. Second, while most of the German government has lost patience with Greece, Chancellor Angela Merkel has not. As the protégé of Helmut Kohl, one of the architects of the Maastricht Treaty, Merkel does not want her legacy to be associated with the unraveling of the eurozone. Merkel has never been so politically strong domestically. At the end of the day, the rest of the German government is likely to bow to Merkel's will.

When (if) a deal is made, it will likely closely represent the terms that German Chancellor Angela Merkel, French President Francois Hollande, European Central Bank (ECB) President Mario Draghi and European Commission President Jean-Claude Juncker set out in a summit in Berlin on 2 June. Following months of dithering from Greece, these players rightly decided that the Tsipras government was incapable of devising a credible reform program so they would have to do it themselves. The Greek government has rejected the take-it-or-leave-it proposal. There is a tiny bit of wiggle room for Greece to negotiate, but Greece's creditors are insistent the numbers still add up. If Greece refuses one measure, it must make up for the fiscal adjustment with another.

Austerity ahead

[1] http://www.bloomberg.com/news/articles/2015-06-11/tusk-says-greece-must-bow-to-reality-as-time-for-gambling-over
[2] http://www.ekathimerini.com/4dcgi/_w_articles_wsite1_1_06/06/2015_550765

There are several sticking points between Greece and its creditors, including the country's primary surplus targets through 2018, value-added tax (VAT) reform, privatisation targets, labour market reform (specifically collective bargaining and minimum wage) and pension reform. Each of these issues is related to Greece's fiscal dynamic and debt sustainability. A rosy scenario for Greece would be if it manages to agree a deal involving reforms somewhere between what it is suggesting and what the creditors are demanding. Even that would require further fiscal adjustment for Greece, with spending cutbacks and higher taxes. That would provide a drag on an economy that has shrunk around by around 25% since the beginning of the crisis and slipped back into contraction in the first quarter of this year[3].

Nowhere are the brutal effects of a likely deal for Greece more obvious than pension reform. This is the issue on which the Greek government and its creditors are furthest apart. According to the Greek government, the troika has demanded that Greece cut EKAS, the pension fund for those at on lower incomes. Pensions have been an absolute lifeline in Greece as the country's social safety net has died a death of a thousand cuts. A recent poll revealed that 52% of Greek households claimed their main source of income is pensions[4]. This is not because so many people are gaming the system and drawing on pensions; it is more because so many Greeks are unemployed without qualifying for benefits or employed but not being paid. If pensions are cut further, a lot of Greek households will really suffer at a time when the economy will likely continue to shrink.

Any version of the deal on the table for Greece will also be painful because absent from it is any kind of debt relief. Greece's public debt burden is clearly unsustainable and must ultimately be written down. The debt overhang is not only an issue because of debt servicing costs and a punishing debt rollover schedule, but also because it provides a huge drag on sentiment and investment.

Best of a bad bunch

If a deal like the one on the table for Greece is so bad, then why would Tsipras agree to it? The alternatives for Greece are much worse for all involved. If no agreement is found by the end of June, Greece will default on its IMF repayments for June. In the absence of a deal shortly thereafter – and there would be little good will amongst the creditors at that stage, to be sure – Greece would also default on its ECB repayments when they come due on 20 July.

The ECB will also have a hard time justifying its Emergency Liquidity Assistance (ELA) program for Greek banks if Greece is not in a bailout program. The ECB has kept Greek banks on life support since the general election in January 2015, essentially plugging the gap in Greek bank balance sheets left by fleeing deposits. The ECB's logic has gone like this: Greek banks are solvent and can be supported by ELA because the Greek government has guaranteed much of the collateral that banks have stumped up in exchange for liquidity. If the Greek government is no longer in a bailout programme, a sovereign guarantee becomes worthless. The ECB will be unable to claim that Greek banks are solvent, and will likely pull the plug on Greek ELA once the bailout expires on 30 June. Capital controls would ensue, with a detrimental impact on Greece's economic performance.

With capital controls, an economy in contraction and no prospect for external funding, Greece could be forced to print its own currency in order to compensate its civil servants. Many policymakers and investors are under the impression that Greece has been ring-fenced and a Grexit would be manageable. They are wrong. The ECB could print away some of the losses from a Greek default and eurozone exit. But the ECB cannot buy up any assets it wants, whenever it wants; it is beholden to the capital key. This could become a real issue the next time the eurozone has a cyclical downturn and Italy in particular gets into trouble. A Grexit could ring the

[3] http://www.reuters.com/article/2015/05/13/eurozone-economy-greece-idUSA8N0W503K20150513
[4] Small Enterprises' Institute of the Hellenic Confederation of Professionals, Craftsmen and Merchants (IME-GSEVEE) - http://greece.greekreporter.com/2015/01/14/13-of-greek-households-earn-less-than-10000-euros/#sthash.ouhK9Kkz.dpuf

death knell for the common currency area. The eurozone would become a currency peg, which is much weaker than a currency union.

Conclusion

No matter how you cut it, Greece has a long, difficult road ahead. The least painful path for Greece is to sign up to a deal similar to that proposed by its creditors. The upside is that this is also the most likely path. The downside is that this will not only result in further austerity and an erosion of what little social safety net Greece has left, it will also only provide enough liquidity to cover Greece's funding needs through to roughly September. At that point we can expect to do this all over again as Greece and its creditors try to negotiate yet another bailout program.