The Greek Debt Crisis

No Easy Way Out

INTRODUCTION

After World War II, farsighted European leaders sought to overcome centuries of hatred and warfare by striving step-by-step toward economic and political integration. Today an ongoing economic crisis in Greece poses a grave threat to that vision, bearing major lessons for the future of global economic cooperation.

Europe’s postwar drive toward unity began with the removal of tariff barriers and proceeded with harmonizing regulations and making it easier for people to move across the region. The European Union (EU), a quasi-political confederation that allowed for the free movement of goods, capital, services, and people, was launched in 1992.

But the introduction of a common currency, the euro, in 1999 proved to be Europe’s riskiest step. (The euro is the official currency of 19 of the 27 EU member countries.)

A decade after the euro was introduced, an unforeseen financial crisis engulfed Europe. It came in the form of a global financial shock that started in the United States after the failure of Lehman Brothers. Major European banks and economies suffered.
One country, Greece, plunged into virtual bankruptcy. In 2015, its leaders threatened to exit the euro. That step might have unraveled the common currency altogether and undermined the “European project,” which took decades to build. The debate over Greece’s threat revived long-dormant nationalist tensions throughout Europe.

Today the Greek economy has stabilized and is slowly recovering. But the huge debts owed by the Greek government to the rest of the euro area cast a shadow over its future and the future of the European project. The Greek populace has suffered painful budget cuts, tax increases, high unemployment, and shrunken living standards and social services. Many still fear their future.

During the crisis, the Greek government and its European and International Monetary Fund (IMF) creditors made tough and even courageous decisions. But there have also been miscalculations, leaving a legacy of fear and mistrust. Each phase in the crisis demonstrates why there was never an easy way out.

**PHASE ONE: THE EURO’S PROBLEMATIC BIRTH**

To fortify the eurozone, members had agreed in the 1990s to what became known as the Stability and Growth Pact. The pact was designed to enforce fiscal discipline and control borrowing by individual countries. Countries running deficits can sometimes print money and generate inflation to ease their debt predicaments, but eurozone membership ruled that option out.

Despite the Pact, the Greek government racked up years of deficits and excessive borrowing after adopting the euro in 2001. Interest rates on its bonds, which normally rise when a country runs deficits, generally stayed low.
Financing institutions may have assumed that any country with a borrowing crisis would be bailed out. They were complacent in the face of Greek deficits. The government’s borrowing spree helped to pay for public services, public wage increases and other social spending. Its borrowing was hidden by budget subterfuge. Warnings about its condition went largely unheeded.

**Greece had the highest average deficit in the EU and lower than average EU growth between 1999 and 2008**

**Source:** IMF World Economic Outlook, April 2019.
Everything went bust in 2009. A new government then disclosed that Greece’s fiscal deficit was far higher than anyone thought, hitting 15.6 percent of GDP in 2011.

**Greece’s public finances were worse than originally estimated**

IMF *World Economic Outlook* forecasts on Greece’s fiscal deficit

![Chart showing IMF forecasts for Greece’s fiscal deficit from 2006 to 2017.](chart)

*Source:* IMF *World Economic Outlook* (editions specified on chart).

Bond markets started to lose confidence in Greece’s economy. The European Union and eurozone lacked arrangements to help the Greek government address its budget shortfalls. Unable to roll over its debts, Athens had to get help from the IMF and euro area member governments.

**Lessons:** Transparency is essential to financial credibility. A monetary union is hampered when it lacks a fiscal union to help members in crisis.

**PHASE TWO: THE “TROIKA” TO THE RESCUE?**

To keep the Greek government from defaulting, various players swung into action. What became known as “the Troika”—the European Commission, the ECB, and the IMF—had to reconcile three pressures.
First was the fear of “contagion” in the European banking system. French and German banks owned much of Greece’s debts. Already weakened by losses from the global financial crisis, they were concerned about shouldering the additional cost of providing debt relief to Greece.

Banks had mistakenly assumed all government debt is risk-free. They had lent to the Greek government on the questionable assumption that it had sufficient capital to absorb a Greek default. All banks in Europe feared that Greek debt relief would set a precedent. Bonds issued by other European governments suddenly became risky, making it more expensive for these governments to borrow. Loss of investor confidence infected the entire European financial system.

A second pressure came from Europeans outside Greece. They did not favor condoning the Greek government’s failure to keep its house in order. Many economists feared that forcing tough austerity on Greece would strangle its economy, making it even harder for the government to repay its debts. But Germans and others in Europe felt that Greece had to suffer the consequences of its alleged misbehavior.

A third pressure came from Greek citizens, who blamed their government and Greek creditors for misleading them. Should blameless young Greek people, wage earners and pensioners have to sacrifice because of the mistakes of irresponsible political leaders and bankers?

Lessons: Financial crises often pose difficult choices over which demands to meet: lenders, borrowers, or citizens caught in the middle.

**PHASE THREE: THE DEMANDS OF “MORAL HAZARD”**

Greek leaders and their rescuers came up with a three-year bailout plan in May 2010. The plan imposed tough austerity on the Greek government and its people to reduce the Greek budget deficit. The retrenchment included tax increases, reduced pensions, public sector wage cuts and looser regulations to restore competitiveness and growth.
In return, the government got up to €110 billion in loans from European countries and the IMF. The ECB also stepped in to buy Greek bonds in the secondary market.

The plan seemed to work at first. Yields on Greek bonds fell. Greece closed its deficit to 5 percent of GDP. But the fiscal consolidation took an economic toll. Greece’s economy sank.

**Following austerity measures, Greece’s economy collapsed**

![Graph showing real GDP index (2007 = 100) with key events highlighted: rescue plan is developed, Greece’s debt is restructured.]

*Source: Eurostat.*

Fearing that Greece would drop out of the euro, creating a financial crisis, Chancellor Angela Merkel of Germany declared a determination to save the common currency by helping Greece. “If the euro fails, Europe will fail,” she said.

But she also called for a stern approach to both “notorious deficit-sinners” and irresponsible lenders—namely, European banks. At a pivotal meeting in 2010 with President Nicolas Sarkozy of France, in Deauville, the two agreed to assist euro area countries in crisis. They also called for “adequate participation of the private sector”—meaning, debt relief, with banks accepting less than full returns on their bonds.

The Deauville announcement rattled bond markets further. Banks feared having to take “haircuts” on the value of their loans. Bond yields spiked, making the prospect of a timely return of Greece to market borrowing even more remote.

In early 2012, Greek debt restructuring took place. It was nominally voluntary. Most investors in bonds went along, since the alternative would have been default. In return, the Greek government got a new package of official emergency loans to be extended in tranches over three years, so that it could meet its expenses while continuing budget cuts.

Once again, the mixture of haircuts and budget sacrifice worked, up to a point. In 2013, Greece achieved a small primary fiscal surplus—the fiscal balance excluding interest payments. But again, the medicine made the patient more sick.
Greece’s economy collapsed. Its economic output declined by 25 percent from the 2010 level. Wages and pensions fell. Unemployment reached 27 percent. And the medicine did not even work in reducing Greece’s debt-to-GDP ratio, which climbed from 130 percent of GDP in 2009 to 180 percent at the end of 2014.

**Greece’s debt situation remains stable but exceedingly high**

**Sources:** Organization for Economic Cooperation and Development; IMF World Economic Outlook, April 2019; World Bank, World Development Indicators.

**Source:** Eurostat.
Forced austerity aimed at enabling the Greek government to pay its debts made it harder to meet that goal.

**Lessons:** There are no pain-free solutions in a financial crisis. But a compromise forged in battle is better than an outright collapse, but even a defensible compromise can make the situation worse.

**PHASE FOUR: THE CAN GETS KICKED DOWN THE ROAD**

Following the private debt restructuring and European intervention, Greek debts are no longer largely in the hands of private bondholders. Instead these debts were held by various public European and international institutions, such as the European Financial Stability Facility, the European Stability Mechanism, and the European Central Bank. Most of these debts had low funding costs and longer maturities, of 20 to 30 years.

**Greek debts moved away from the hands of private bondholders to European and international institutions**

<table>
<thead>
<tr>
<th>Greek central government debt by creditor, percent</th>
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<tr>
<td><strong>December 2012 (after crisis)</strong></td>
</tr>
<tr>
<td>New bonds</td>
</tr>
<tr>
<td>European Union/European Financial Stability Facility</td>
</tr>
<tr>
<td>56.0</td>
</tr>
<tr>
<td>T-Bills</td>
</tr>
<tr>
<td>8.5</td>
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<tr>
<td>ECB/NCBs</td>
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<tr>
<td>15.7</td>
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<tr>
<td>IMF</td>
</tr>
<tr>
<td>7.7</td>
</tr>
<tr>
<td>Holdouts</td>
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<tr>
<td>1.9</td>
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| June 2010 (before crisis)                     |
| Bonds                                         |
| European Union/European Financial Stability Facility |
| 80.5                                          |
| T-Bills                                       |
| 2.3                                           |
| ECB/NCBs                                      |
| 1.9                                           |
| IMF                                           |
| 1.8                                           |
| Other debt                                    |
| 9.0                                           |

*ECB = European Central Bank; NCBs = other national central banks in EU/euro area; IMF = International Monetary Fund

**Sources:** European Commission; Greek Ministry of Finance; IMF.

The transfer of debt from the private sector to European official creditors changed the political dynamics of the Greek crisis. Nationalist sentiments stirred in many European countries. At the same time, public opinion in Greece turned against Europe and its forced retrenchment of the Greek economy.

In early 2015, Greeks elected a new anti-austerity government led by Alexis Tsipras of the left-wing Syriza party. They attacked the Troika and demanded more debt relief, less fiscal restraint and a rollback of some of the previous reforms. The Eurogroup—the club of euro area finance ministers—objected. They insisted that Greek leaders "finish" their previous program before discussing a new one.

The confrontation rekindled the crisis. European leaders wanted to extend lending to Athens to avert a decision to abandon the euro. But European leaders also did not want to give in to what they perceived to be blackmail by the Greek government. They
feared that a Greek default would provoke a new banking and economic crisis that could unravel the euro itself.

In June 2015 Greek leaders rejected a Eurogroup offer for more assistance conditioned on continued adherence to fiscal discipline. The ECB reacted by refusing to extend additional emergency liquidity to Greek banks.

Facing a run on deposits, the Greek government imposed capital controls and cash withdrawal restrictions. The government also missed a payment to the IMF of €1.5 billion. Had the stalemate continued, Greece would have been forced to introduce its own currency, effectively exiting the euro.

But the threat of crisis led again to compromise. In August 2015, Greek leaders agreed to a new reform program in exchange for immediate cash and the promise of up to €86 billion over the next three years.

The new program required somewhat less austerity than previously demanded. Tsipras won re-election in September. In 2016, Greece exceeded expectations by posting a large primary budget surplus, of almost 4 percent. Unemployment began a slow decline, and growth returned to positive territory in 2017.

Despite these signs of stability, Greek voters were still suffering from the EU-imposed austerity in summer 2019. They were also resentful that the European Union had pressured Tsipras to allow Greece's northern neighbor to use the terms “Macedonia” and “Macedonian,” which many Greeks felt were uniquely owned by Greece. The combination of economic, political, and cultural resentments led to Syriza's election defeat and Tsipras's ouster as prime minister. The new prime minister, Kyriakos Mitsotakis, leads a center-right coalition that has promised to cut taxes—a plan sure to provoke skepticism among European creditors.

Despite signs of stability, Socialist party is crushed in the 2019 elections by center-right coalition promising tax cuts

<table>
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<tr>
<th>Greek parliament by number of seats for each party</th>
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<tbody>
<tr>
<td>2019</td>
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<tr>
<td><img src="image" alt="Graph showing seats for each party in 2019" /></td>
</tr>
<tr>
<td>2015</td>
</tr>
<tr>
<td><img src="image" alt="Graph showing seats for each party in 2015" /></td>
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**Source:** Politico.

The Greek government’s debt situation remains precarious: stable but still exceedingly high at 180 percent of GDP. In mid-2018, Greece's official European creditors offered the Greek government some further maturity extensions and interest deferrals. In return, Greek leaders pledged to maintain a primary surplus of 3.5 percent of GDP until at least 2022 and of over 2 percent of GDP on average until 2060.
Another debt crisis looms in Greece

No country has sustained such high surpluses for that long. In fact, in May 2019, Athens lowered its surplus targets. Unless the Greek government’s private borrowing rates remain exceedingly low for decades, or the Greek economy grows faster than expected, Greece’s next debt crisis will be just a matter of time.

Lessons: Temporizing and hoping for a better future may resolve immediate crises, but at the risk of leaving a legacy of unsolved problems for the next generation.

Questions for Discussion

1. Imagine you are head of a French bank loaded with Greek bonds that are losing value in 2010 at a time when Greece is swimming in red ink from budget deficits. What do you want Greek and European authorities to do to protect your investments?

2. Imagine you are a Greek worker who has lost his or her job or pension because of the financial crisis. What must the Greek government and European authorities do to help you in a situation not of your own making?

3. Imagine you are an official at the European Central Bank. What is the best course to rescue Greece while preserving the solvency of European banks and making sure Greece does not repeat its mistakes?

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Note: Shaded areas depict percentiles for forecasts: 10, 20, 30, 40, 50 (line), 60, 70, 80, 90. Assumes long-run growth at 1 percent. Uncertainty stems from growth, inflation, and interest rates.

Source: Calculations by Jeromin Zettelmeyer, methodology described in PIIE Policy Brief 18-10, How to Solve the Greek Debt Problem.