# Does Greece Matter?

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## Of Course Greece Matters…

… to the people of Greece… to the European Union… to anyone with empathy for the suffering of the people of Greece.

Based on Bloomberg International Monetary Fund data, Greece GDP has fallen by 25% since 2008 and is near levels not seen since 2000 – no growth for almost 15 years. The unemployment rate has been over 25% for the past three years. In February 2015, youth unemployment exceeded 60% (Reuters). A 2014 medical study (BMJ Open) documented a 35% increase in suicides after a round of austerity measures introduced in June 2011. More than 450,000 families have no working members (globalresearch.ca) in a country of just 11 million people.

If this is not a Greek tragedy and great depression, I don't know what is. More austerity – spending cuts and tax increases – to solve the problem is akin to the use of leeches to cure ills during the dark ages of medical practice… just drain a little more blood and you will be cured!

## Greek Debt

To be sure, Greek policymakers bear responsibility for allowing their country to fall into such dire straits, perhaps beginning with the decision to join the Eurozone. However, what needs to be cut, and will be cut one way or another, is Greece's debt burden.

**Greece's public debt, estimated at €325 billion, is near 175% of GDP. To shrink the debt-to-GDP ratio, the economy must grow faster than the debt**.

Currently, Greece's nominal GDP growth (real growth plus inflation) is running at negative 1.1%. The Greece budget deficit is 3.5%, including interest on existing debt. **So, currently, debt is growing at 3.5% per annum and nominal GDP is shrinking at 1.1% per annum. Debt-to-GDP is set to continue to rise.** If debt is not reduced in some way, then the only solution is for nominal GDP to rise. Austerity is not a method to stimulate growth.

## The Greece Default

If Greece were not in the Eurozone and had control of its own currency, they could devalue their currency to both stimulate growth through improved competitiveness (think exports and tourism) and reduce the debt burden relative to GDP through higher inflation. Being part of the Eurozone, Greece does not have this option.

It is useful to think of currency devaluation as a partial default. If you take devaluation to an extreme (debasing a currency through hyperinflation), bondholders get paid back in worthless currency. It is no different than default, as bondholders get effectively nothing in either case.

Greece is already in default, although no one wants to use the word. They have missed a payment to the International Monetary Fund (IMF). The only question is how big the ultimate default will be and whether it is a controlled default or chaos. If the Eurozone leaders force Greece to exit the Eurozone, Grexit as it is referred to, then the default will be chaotic and creditors will get little.

On the other hand, if creditors are willing to negotiate, then a debt restructuring or haircut (other words for partial default) can occur along with negotiated structural reforms for the Greek economy.

How Greece defaults will be a collective political decision among the parties

## The Political Calculus

The Eurozone leaders and creditors hold the upper hand in terms of the path to Greece's default. If they want Greece to stay in the Eurozone, then there will be a negotiated settlement. If not, then Grexit, with all the chaos, is a real possibility. It is also possible that Greece repudiates its debt and stays in the Eurozone. This would be analogous to a municipal default in the U.S., if the Eurozone leaders would allow it.

Of the €325 billion of Greek public debt, about 80% of it is owed to public institutions – the Eurozone member states, the European Central Bank, the European Financial Stability Facility, and the IMF. Germany alone has an estimated exposure in excess of €90 billion. If it were possible for Greece to default on just this debt, they would collapse their debt-to-GDP ratio, and the tax payers supporting the public institutions would subsidize the loss. This is the nature of the math that will go into the political calculus.

The more important aspect of the political calculus for the Eurozone leaders is the consequences of Greece exiting the Eurozone. There are two primary schools of thought.

1. The Eurozone will be stronger without Greece, and Greece's exit will serve as a warning to other countries bridling under the social impacts of austerity and the limitations on their sovereignty.
2. The Eurozone will be weaker because the perceived irreversibility of the Eurozone membership will be pierced and other weaker countries may determine that it is their sovereign interest to exit as well.

Of course, no one knows the likely political outcome, but on balance, it seems that it is in the mutual interest of Greece and its creditors to come to a negotiated settlement.

## The Economic Calculus

So, how does this impact markets and your investments? In the short run, the markets will remain volatile until the crisis is on a clear path to resolution. Once we are on this path, the euro will be in a position to appreciate on a long-term fundamental basis.

The euro has depreciated by about 20% over the past year. The Organization for Economic Cooperation and Development (OECD) estimates the euro is now undervalued by more than 15% on purchasing power parity basis (PPP). A more intuitive measure, the Big Mac Index of PPP (what is the difference in cost for a Big Mac in the U.S. and a Big Mac in the Eurozone at current exchange rates), the euro is undervalued by about 15%.

In addition, the Eurozone is running a current account surplus of about 2.25% of GDP, and the U.S. is running an equivalent deficit. The current account balance is a broad measure of trade, income flows and transfers for a country. A surplus indicates a competitive advantage, puts upward pressure on a currency over time, and vice versa.

That said, in the short run, currency movements, as well as market movements, are dominated by market participants' emotions and perceptions, and the path of euro appreciation can be very bumpy depending on the degree of "hysteria" surrounding Greece.

But it is just that – hysteria for everyone but the Greeks who are suffering. In economic terms, Greece is a small country. It is about the size of greater Miami, 2% of the Eurozone economy, and about 1/3 of 1% of the world economy. Its fate is not significant to major world markets unless collective fear allows it to become so.

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