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The neverending story

The story of Greece's flirtation with European defenestration is the story of Europe's failures: the inconsistencies at the heart of the eurozone's design, the solutions that have only made matters worse, and the reluctance to make any decision today that can be put off until tomorrow. Today, Greece stands on the brink of exit, as it has many times. Will this be the time it steps over the edge?

For years, talk of a possible Greek exit from the eurozone has refused to go away. Less often discussed are the plethora of other possible outcomes in Greece's a la carte menu of financial ignominy.

"Default is not the same as a missed coupon, and nor is introducing capital controls," said Alberto Gallo, head of European macro credit research at RBS. "Even unilateral default would not necessarily lead to exit. People automatically jump to Grexit, but a lot needs to happen before we get to that."

Even if Greece does leave the eurozone, that prospect does not scare markets as badly as it once did. While the fear of contagion has subsided in recent months it remains a concern because of the precedent it would set, weakening the cohesion of the union as a whole.

Analysts stress that a default to the IMF or ECB would be counter-productive. While it would save money in the short term, Greece would no longer have access to the support mechanisms the institutions offer to struggling economies. Many feel it is more likely to raise taxes or raid its pension funds for the money than default to these institutions, a view that was supported by Greece managing to find the cash to make its most recent IMF payment on May 12.

But with Syriza conducting its discussions behind closed doors, it is all guesswork.

What does seem increasingly clear is that the original plan to cut spending to balance the books has not worked.

“The bailout programme for Greece was too austere and pushed it into recession with a 25% decrease in consumption per capita,” said Sylvain Broyer, head of economics at Natixis. “The impact was felt disproportionately by the poorest and rich Greeks were not affected. I think that the ECB and other EU representatives acknowledge the impact this had on social unrest and know they made a mistake.”

When the EU and Greece agreed to a haircut on Greek debt in 2012, debt to GDP was about 125%. It is now 180%, with GDP having plunged by 25%. Greece targeted growth of 3% this year but instead is looking at a forecast deficit of 1.5%.

All this demonstrated the failure of Europe’s Greek policy, said Dimitris Paraskevas, managing partner of Paraskevas Law in Athens. “This is the biggest fall in GDP by any country in the world, ever, except for the US during the depression. Europe did not accurately calculate the impact of austerity,” he said.

Whether this realisation will come in time to save Greece remains unclear. Some argue that a more conciliatory stance on Greece's part would have seen greater concessions from Europe. Instead, Syriza's bellicose stance has forced it to dig its heels in, even as it reviews its policy of austerity elsewhere.

"Austerity is dead," said Broyer. "This year, Europe's fiscal policy will be neutral and in 2016 there will be a 0.25% expansion. Considering the ECB is also expanding monetary policy with QE, that represents a complete U-turn in European policy. It remains to be seen what impact this will have on consumer confidence."

Low rates that reduce the cost of servicing debt have been perhaps Europe's most important weapon in fighting its broader growth crisis. Once seen as a temporary measure to kick-start the economy, it now looks increasingly likely to be a more persistent fixture – in the US as well as Europe – much like it has been in Japan.

"I don't think rates will go up quickly to the levels we have seen in the past," said Giovanni Zanni, an economist at Credit Suisse. "Low rates will be persistent, which gives Europe space to grow through the fiscal channel."

Fundamentally flawed

The eurozone is far from an optimal currency area, given the enormous differences between the economies it comprises. This problem is not exclusive to Greece: all countries in Europe have different levels of competitiveness and have to live with a one-size-fits-all monetary policy.

"Greece is diverting attention away from the real problems in Europe, the likes of France, Italy, Spain," said Marcus Svedberg, chief economist at East Capital. "Greece's problems are uniquely Greek, while the problems in those larger European economies better illustrate the fundamental problems of the continent as a whole."

Everyone would agree that if they were to start the project again, things should be done differently. But there is no political will to start again, or to abandon the project into which so much time and energy has been invested. So the only way forward is towards further integration, albeit in gradual lurches, rather than via a coherent strategy.

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This is happening, as evidenced by its steps towards banking union. Financial regulation across the block is increasingly harmonised, even if regional interpretations remain. However, the patchwork of languages across Europe impede the theoretical freedom of movement that would make the single market work most effectively.

Of course, Europe is not the only currency union that spans linguistic and cultural divides. Canada and Switzerland are both multilingual countries with a single currency. While economies such as the US now look fully integrated, it took many years for that to happen and in the early days of the dollar the social and economic differences between the regions were acute enough to trigger civil war.

Nothing so dramatic looks likely in Europe today. But many still argue that the only thing that can make the eurozone work is fiscal transfer from the prosperous north of the area to the poorer south – arguably already happening by proxy.

“In the absence of a formal fiscal union, the Greece bailouts represent fiscal transfer through the back door,” said Svedberg.

A more formalised arrangement would have more credibility, and would come alongside closer political union. But even if this wish-list were granted, its success would not be guaranteed.

“Even if there was full political union that would not guarantee no more problems in the future, just look at the issues Scotland is having in the UK,” said Zanni.

Lee Hendry, macro credit analyst at RBS, said: “Europe looks to be heading towards greater integration without full fiscal or capital markets union. It is developing some common rules and a banking union and a common deposit scheme, for example, which will make the eurozone stronger.” New stabilising mechanisms are being sought for smaller countries, with RBS arguing that growth-linked bonds could be a solution.

Europe-wide, the problem of large current account deficits is not as bad as it was. Italy has a surplus, Portugal and Spain are more or less in balance. While most of Europe – including some of the other troubled, so-called PIGS – has seen spreads on a tightening trend, Greece’s have steadily widened. This increases the sense of Greece’s isolation, and that it is a unique case in Europe.

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It also feeds resentment at its perceived unwillingness to make the kinds of reforms other countries have subjected themselves to.

"Greece looks isolated. It had the chance to restructure and reform itself to meet the euro rules but it was stopped by the current government," said Zeina Bignier, global head of public sector origination at Societe Generale Corporate & Investment Banking.

"Now European public opinion is changing, there was some support for Greece but this has disappeared as it has become clear that Greece is not willing to make the necessary reforms, as countries like Cyprus, Portugal and Ireland were."

Reform: easier said than done

Greece's problems do not lend themselves to simple solutions. It shares many of the problems suffered by Europe as a whole, such as its ageing population – and combines them with far deeper economic malaise than any of its peers.

It is not hard to see this evidence. Most international banks have moved out of Greece; only HSBC remains with branches in the country. Many smaller companies have left for countries such as Bulgaria, which offers a lower tax rate.

Greece also has the least well-defined property rights in Europe.

“The Greek state is weak by European standards,” said Broyer. “In some areas such as property rights, payment morale or statistical transparency, it looks more like a country of the Balkans than the rest of the eurozone.”

If Greece had the option to aggressively devalue its currency, or if the eurozone had the usual hallmarks of a political and currency union with better mechanisms for internal redistribution, it might have been able to alleviate some of the pressure in its economy.

Stuck between these ideal positions, Europe has instead prescribed structural reform – in addition to austerity – as its medicine, and the prerequisite to the final tranches of its bailout funds.

There is no single solution to this economic problem. Privatisations will play a crucial role. The state has assets that are already attracting a lot of interest, with reports suggesting that Greece could sell airports or even whole islands to balance the books.

Meanwhile, the church in Greece owns around €750bn worth of real estate in the country, twice its public debt. Some have argued that Greece should cash in on that asset.

Transforming the debt so it pays a zero coupon is against European rules but Europe seems to be looking at how to extend the maturities and reduce the rates of interest to make the debt more manageable.

Hendry at RBS said: “Greek debt sustainability can only be achieved in incremental steps, pushing through reforms, paying down debt and negotiating some of the burden on to its creditors.”

And it needs time. “Greece has a debt-to-GDP ratio of 180% and if it is going to reduce that to 120%, it needs a reasonable timetable to do it in,” said Guillaume Menuet, an economist at Citigroup. “If it has five years, that will be impossible, but over 10–15 years it could be manageable.”

Europe has acknowledged this fact by relaxing Greece’s repayment commitments to the point that its spending on debt interest as a proportion of GDP is the same as it is in Germany.

Now, the focus needs to now shift to structural reform, said Menuet, adding: “Raising potential GDP in Greece can be achieved if the pace of adjustment is gradual. Ending fiscal consolidation will buy Greece some growth which should make it easier to deliver on its reform programme.”

But in order to pass reform, Greece needs to strengthen its state apparatus. “European authorities want Greece to develop institutions up to at least a minimum European standard,” said Peter Schaffrik, head of UK and European rates and economics research at RBC.

Greece has taken important steps in this regard, such as forming a land registry, and it is working hard to improve its tax collection. Yet many outside Greece feel the country is showing the rest of Europe a lack of respect by its flagrant unwillingness to reform.

“There has been little progress on reform in this parliament,” said Bignier. “In fact, this government is undoing some of the hard work of the last government.”

Taxing issues

Specifically, Greece has made most progress in the areas where its aims are aligned with those of the rest of Europe and the IMF. Both sides agree it needs to crack down on tax evasion.

Progress has stalled in the more controversial areas, such as austerity and labour market deregulation.

“But in these areas, even within the IMF there is some disagreement, so it makes sense for Greece to hold out to see if support for its position grows,” said Hendry.

Even where all sides agree on the need for action, meaningful progress is hard to come by. Because tax collection is still so weak, rising taxes are disproportionately punishing those who pay. There has been some discussion about how Greece could tax its citizens that live abroad, as many other countries do, but this remains a pipe dream while it is incapable of taxing those still at home.

“In the last years there have been at least 20 new tax laws, and there are more than 1,000 explanatory circulars,” said Paraskevas. “In simple words, nobody understands the tax environment.”

It does have the beginnings of a plan, however.

“It is very hard to monitor payments and consequently untaxable income in Greece, so the government’s plan is to introduce a law requiring all payments of more than €70 to be settled with credit/debit cards, encouraging a shift away from cash payments,” said Paraskevas.

“This will help Greece tackle the estimated €10bn in uncollected annual VAT payments. In addition, as a tax reform, the Tax Collection Authority will be a government independent body. ”

Implementation will take time, given the lack of card payment infrastructure in Greece. But if it remains committed to the task it should make a difference – especially if it comes along with reform of the tax code.

"We need to encourage entrepreneurship among our young people and tackle the common mentality that the private sector can survive on government contracts. We need a smaller, flexible, efficient and more meritocratic state. This is not the direction the current government is driving us to," said Paraskevas.

Greece must look to its neighbours for ideas, said Paraskevas, including Bulgaria, and its low taxes and simple tax laws and rules.

"In such a case business people will be able to plan their cashflows and I dare say they would be happy to pay their taxes. Nevertheless, our creditors are pushing us the other way, to raise taxes in order to compensate for the inefficiency of collection. In the short run such a policy may lead to fiscal surpluses, in the long run though it is sure that it will lead to economic recession and poverty."

Not entirely unique

While in many ways Greece looks an outlier in Europe, in at least one way it looks quintessentially European.

"The way that Greece is representative of the eurozone as a whole is its increasing political fragmentation and the reaction of its public to austerity," said Broyer. "The eurozone needs to prove it is more than just a currency area, but an agent of social justice. It needs to embrace some level of regional income redistribution – as it does in the US – or the eurozone has no future."

The success of Syriza has echoes in the rise of Euroscepticism across Europe, but it has taken different forms in different countries.

“Syriza isn’t anti-European in the way Britain’s UKIP is, it is only against the policies currently favoured by Europe’s leaders,” said Schaffrik. “But while Greece’s influence in Europe is quite small, there are voters across Europe who share its opinions. Over the next two years a lot of European countries have national elections, so it is possible the anti-austerity view may be better represented.”

“Europe is more popular in Greece than it is in Italy and I don’t see a dramatic deterioration of sentiment towards Europe in Greece,” said Zanni. “In fact, it seems support for Syriza has started to decline a bit as people question its handling of the negotiations. I think Europe’s reputation could come out of this enhanced if it shows politicians with very different points of view can negotiate and reach a deal.”

In working with Europe to find a deal, Syriza could ultimately find itself moving towards the centre, the realities of office forcing it to tone down its belligerent stance and adopt a more mainstream left-wing position. Eventually it could replace Pasok as the mainstream left-wing party of Greece, perhaps incorporating other small Greek parties of the left.

Alternatively, Syriza could collapse under the weight of disappointment among Greek voters, given its failure to deliver little on the grand promises it made in getting elected. And if the mood in Greece is to some extent representative of the electorates across Europe, perhaps Europeans will conclude that other extremist parties preaching an anti-European message will prove similarly incapable.

There is evidence this is already happening, with support for Podemos in Spain already reportedly on the wane and the new, more centre-right Ciudadanos gaining considerable ground. In the UK general election, UKIP failed to make the gains many had predicted.

The struggle is far from over. But while nobody has so far made money betting on Greece leaving the euro, it would be a brave call to bet against Europe’s powers of survival.