National Institute of Economic and Social Research

Press Release

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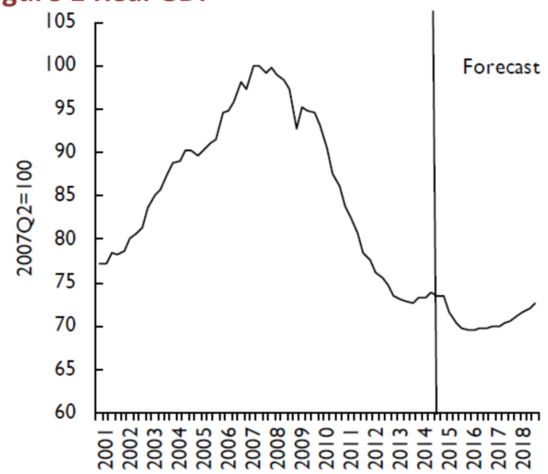
Greece and the Euro

If the "troika" continue to insist on unrealistic fiscal targets, the Greek economy will remain in depression. According to our modelling, restoring debt sustainability requires a debt write-off equivalent to at least 55 per cent of GDP, higher than the IMF's estimate of 30 per cent. More broadly, recent policy announcements among euro zone policymakers risk turning a monetary union into a mere fixed exchange rate system. This is according to new research out today, published in the *National Institute Economic Review* by the National Institute of Economic and Social Research (NIESR).

Figure 1 Real GDP



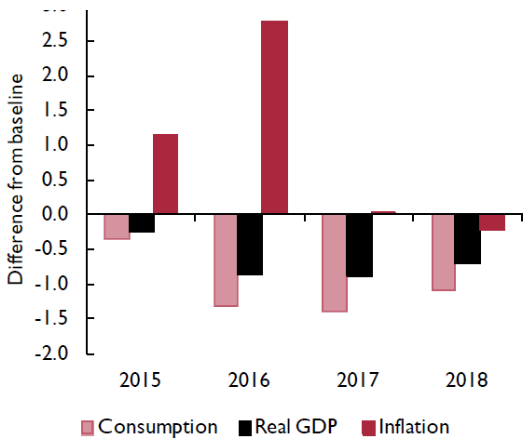
Source: NiGEM database and NIESR forecast.

The economy is expected to contract sharply again this year and next, with GDP falling 3 per cent in 2015 and 2.3 per cent in 2016. We expect the recession to end in mid-2016. At this point the economy will be more than 30 per cent smaller than at its peak in 2007 and smaller than when it joined the Euro Area in 2001 (see Figure 1).

NIESR's analysis finds that the proposed changes to VAT outlined by the government would exacerbate the current situation, prolonging the recession even further (see Figure 2). Furthermore, continued insistence on aiming for unrealistic primary budget surplus targets while the economy remains depressed will not allow meaningful growth to resume. Jack Meaning, Research Fellow at NIESR, argues:

"The changes to the VAT system will hit already weak consumer spending, shrinking the economy even further this year and next. It will also mask some of the underlying deflationary pressure this year and next."

Figure 2 The impacts from changes to Greek VAT rates



Source: NiGEM simulations.

Greece's current level of public debt is unsustainable, with its banking system dependent on Emergency Liquidity Assistance from the ECB. Simon Kirby, Head of Macroeconomic Modelling and Forecasting at NIESR, argues *"a transition to a sustainable debt position will require reductions in Greece's national debt through the form of a permanent fiscal transfer from the rest of the Euro Area."* Restructuring, or writing off, €95 billion (55 per cent of Greek GDP) provides Greece with, at least, a chance of lowering its debt stock to the target levels of the original bailouts (around 120 per cent of GDP in 2020). More could be done. Given the uncertainties involved, the authorities do not appear to have heeded one of the lessons of earlier financial crises: it can turn out to be a lot cheaper to buy too much insurance than too little.

The fiscal transfer from Euro Area members required to achieve this would represent 1 per cent of Euro Area GDP in one year. As it would be spread over many years and across the membership, we argue the impact on other Euro Area members would be minimal, and that this fiscal transfer is necessary if Euro Area membership is to be maintained.

The situation in Greece naturally raises some wider issues for the Euro Area, and some fundamental issues regarding the design and implementation of European Monetary Union. The concept of the irreversibility of the Euro project has been openly challenged by Euro Area policy makers. The design of the ECB's quantitative easing programme actually concentrates risk in national central banks rather than shares risks across the system. The ECB will only hold a small percentage of purchased assets (20 per cent) on its balance sheet, limiting risk sharing between member states. Moreover, the unnecessary interference with the functioning of the ECB by politicising its profitability limits its room to support the Euro Area. Dr Angus Armstrong, Director of Macroeconomics at NIESR, argues that by seeking to limit or constrain these potential losses:

> *"Politicians are creating a risk of turning the monetary union into a system of fixed exchange rates."*

NIESR's analysis and forecast assumes that a third bailout agreement is reached and Greece remains in the Euro Area. This is not to deny the large chance attached to a Greek exit. Certainly, as the prospects for Greece deteriorate while inside the Euro Area, questions over Greece remaining a member will persist.

While the establishment of a new currency in Greece is clearly fraught with risks, there may come a point where the calculus simply no longer favours remaining within the Euro Area. It may seem surprising that many within the Euro Area appear prepared to accept these risks. However, this is consistent with the behaviour of creditor nations in monetary unions in the past: creditor rather than debtor nations are always the ones to determine the final outcome of monetary unions. The irony is that if Greece is forced to leave the single currency, the losses which creditors would face are far greater than the debt write-down required to enable Greece to remain in the Euro Area.

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Notes for Editors:

1. This press release is based on an article entitled "Greece and the Euro Area", written by Angus Armstrong, Oriol Carreras, Simon Kirby, Jack Meaning and Rebecca Piggott, and published in the *National Institute Economic Review No. 233 August 2015*.

   This is a quarterly, peer reviewed, economic and social sciences journal. The full *Review* is published from midnight on Wednesday 5 August.
2. For a copy of the article, or to organise an interview, please contact Brooke Hollingshead in the NIESR press office on 020 7654 1923 / b.hollingshead@niesr.ac.uk
3. To discuss the article please contact:
   - Simon Kirby: s.kirby@niesr.ac.uk or 0207 654 1916
   - Jack Meaning: j.meaning@niesr.ac.uk or 0207 654 1944

- Angus Armstrong: a.armstrong@niesr.ac.uk or 0207 654 1925

For further information:

National Institute of Economic and Social Research
2 Dean Trench Street, Smith Square
London, SW1P 3HE

Switchboard Telephone Number: +44 (0) 207 222 7665, Website: http://www.niesr.ac.uk