

Comment

Greek woes and the SA economy

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Introduction

The Greek debt crisis took a turn for the worse during the past week after Prime Minister, Alexis Tsipras, unilaterally called a referendum for Sunday, 5 July. The Greek population will be asked to vote on whether they accept the creditor conditions tied to the next tranche of Greece's bailout package. Led by Tsipras, the Greek government is actively campaigning for a vote against the package. Despite this, Tsipras requested that the creditor troika (IMF, ECB and the European Commission) extend the previous bailout until after the referendum.

This was rejected by Eurozone (EZ) finance ministers at a meeting on Saturday, and followed by an ECB decision to cap its Emergency Lending Assistance (ELA) to Greek banks. The ECB liquidity had kept the banking sector afloat and the cap forced the introduction of capital controls, the closure of banks and the stock market from Monday. Crucially, Greece missed a €1.6bn IMF loan repayment on Tuesday and is now officially (as in the case of a country like Zimbabwe) in arrears with the IMF. In so doing, Greece became the first developed country to miss an IMF debt repayment. Although the Greek crisis has been dragging on at least since 2010, the most recent breakdown in debt negotiations has raised the possibility of a Greek exit (Grexit) from the EZ and the potential for accompanied global financial market turmoil. This brief note explores the impact that a further deterioration in the Greek situation, especially if the Greek population vote against the conditions tied to the bailout on Sunday¹, could have on the South African (SA) economy.

How could Grexit materialise?

From the onset it is important to emphasise that a lot of uncertainty surrounds the exact mechanism through which Greece would be forced to leave (if indeed it was) the EZ and potentially the European Union as well. Furthermore, even if the Greeks reject the creditor proposals in Sunday's referendum, it will not guarantee a Grexit. Nevertheless, and simplified, a "no" vote could push the country closer to exit. To emphasise the point, the *Financial Times* quoted Dutch Finance Minister Jeroen Dijsselbloem as telling a parliamentary committee that: "One illusion must be swept from the table, that if the outcome is negative then everything can be renegotiated and you will end up with an easier and more attractive package. If

¹ Although nothing is for certain, effectively this will be a vote against continued Eurozone membership.

people say they don't want that, there is not only no basis for a new programme, there is also no basis for Greece in the Eurozone.”

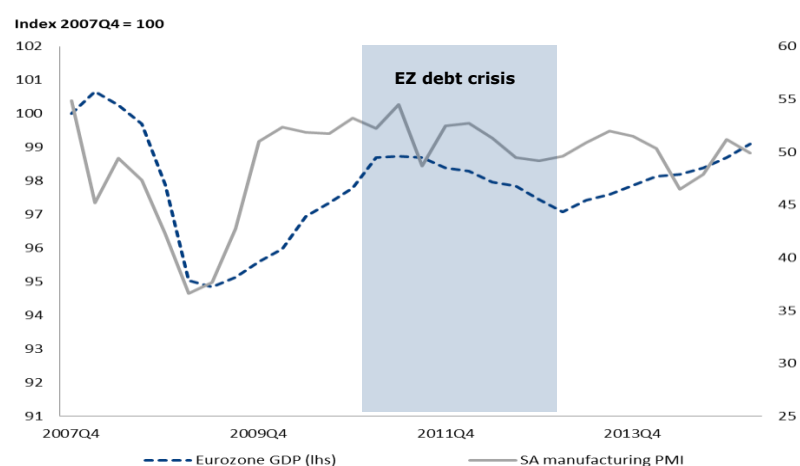
In the aftermath of such an outcome, the ECB may decide to totally suspend ELA to Greek banks. This is likely to result in a collapse of the Greek banking sector. Under these conditions, the only feasible way to inject new liquidity into the banking system is for Greece to leave the single currency and start printing its own currency again.

Channels of contagion

Financial market and / or real economy instability in one country can impact trading-partner countries through two distinct channels. The first is through reduced demand for imported goods from trading partners, i.e. the **trade channel**. The other is through **financial market linkages**, i.e. a crisis in one country weighs on global investor sentiment. Investors then react in a way that transmits the panic to global markets. This can include the foreign exchange, stock and government bond markets.

In the case of Greece and SA, the trade channel is negligible. Indeed, customs data for the first five months of 2015 reveal that SA exported goods worth R250 million to Greece. This equates to only 0.06% of total domestic exports over the period. SA exports will therefore suffer very little, if any, direct impact from a further weakening in the Greek economy. There could of course be a bigger impact if the Greek problems weigh on GDP growth in the wider EZ economy. The EZ remains an important market for locally produced agricultural and manufactured goods. According to the World Bank, in 2013, Greece was responsible for less than 2% of overall Eurozone GDP. It is therefore unlikely that a further decline in the Greek economy will have an untoward direct negative impact on broader EZ growth.

Figure 1: EZ GDP remains a key driver of SA manufacturing output



Sources: OECD, BER

However, this does not take account of the potential that a deterioration in the Greek situation could have on consumer and business confidence in the wider EZ. A severe knock to already fragile confidence levels could have negative spill-over effects to the EZ real economy. This will dampen the demand for locally

produced goods and will come just when the EZ economy is finally starting to show some sign of life (see figure 1).

The more important impact on the SA economy is likely to be felt through the financial market channel. Periods of global uncertainty and increased risk aversion have generally led to increased volatility on global and domestic asset markets. This was again the case earlier in the week when the Euro gyrated in fairly large ranges against the US dollar. At least initially, global stock markets and the rand were under pressure as well. The JSE was also impacted, declining by up to a 1, 000 points at one stage on Monday. There is certainly a risk for increased volatility and potentially accelerated losses if the Greek situation deteriorates further. This will be especially the case if the Greek population votes “no” in Sunday’s referendum. However, after the initial knee-jerk reaction in markets on Monday, they have for the most part been remarkably calm during the rest of the week. Although financial markets may be underestimating the potential fallout from the Greek referendum and potentially a Grexit, there are a number of arguments in favour of fairly limited short-term contagion effects from Greece. These include that:

- The exposure of the global banking sector to Greek debt has been reduced dramatically over the last number of years. Greek debt is now mainly owned by public entities such as the IMF and the European Financial Stability Facility (EFSF) with limited private sector exposure.
- Other periphery European countries such as Spain, Portugal and Ireland have made substantial economic adjustments since the 2010-12 Eurozone debt crisis. As an example, Deutsche Bank highlights that these countries all had current account surpluses in 2014. This makes them less vulnerable to contagion. Figure 2 highlights that despite the recent adverse events surrounding Greece and a global bond market sell-off, periphery bond yields have (although moving higher) remained relatively well behaved. They certainly remain well off the peaks reached at the height of the EZ debt crisis. Indeed, to date there has been no evidence to suggest that the other periphery countries are suffering capital flight.

Figure 2: 10-year bond yields in selected EZ periphery countries



Source: Reuters

- Compared to 2010, the ECB is in a much stronger position to support other countries that run into liquidity problems due to Greek contagion effects. This could be done through the bank's quantitative easing (QE) and other programmes. Furthermore, the European Stability Mechanism, the bloc's bailout fund, has in excess of €450bn to support solvent countries that run into liquidity, or short-term financing, problems.

A Greek exit from the EZ is sure to result in a lot of initial uncertainty and panic with lower stock market values and a weaker than expected rand exchange rate a distinct possibility. That being said, the factors listed above suggest that the fallout is likely to be much less severe than would have been the case earlier in the decade. However, the exact magnitude of any potential contagion is highly uncertain. SA's weak GDP growth prospects, as well as the twin current account and budget deficits, do expose us to a sudden shift in global risk sentiment. On a more positive note, in a worse-case scenario where Greece is forced out of the EZ, the accompanied uncertainty may delay the start of US interest rate normalisation. The SA Reserve Bank (SARB) has repeatedly expressed concern about the potential adverse foreign capital flow implications of a higher US policy interest rate.

Domestic policy response to Greek contagion

SA policy makers do not have a lot of ammunition to support the domestic economy in the event of a turbulent Greek exit. Rising government debt levels suggest limited scope to stimulate the economy through fiscal policy. While the monetary authorities could reduce the repo policy rate, a deteriorating consumer inflation outlook and rising inflation expectations provide almost no room for an interest rate reduction.

However, concern about the adverse impact of Greek contagion on an already fragile domestic economy could force the SARB's hand in delaying a widely expected resumption of interest rate increases in the second half of 2015. This will especially be the case if Greek turmoil shifts out expectations about the start of Fed interest rate normalisation.

Conclusion

The probability of a bad end to the Greek debt impasse has increased notably over the past week. SA's trade links with Greece are limited, which should shield the country against a further decline in Greek GDP. The concern is rather about financial market and confidence spillovers that have the potential to weaken the rand exchange rate and depress domestic equity and bond markets. Although it is almost impossible to gauge the potential fall-out from a Grexit-type event, a number of developments since the height of the EZ debt crisis in 2010-12 suggest that the contagion effect should be less this time around.

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