What would a Greek exit mean for the Eurozone?

Dear readers,

Greece's future in the Eurozone is back on the international economic and political agenda. For the last few weeks, Eurozone governments have been negotiating amendments to the terms of Greece's bailout programme. An agreement has been reached, for now, to extend the programme by four months, and thus avoiding a possible Greek exit driven by the expiry of the Eurozone bailout package at the end of February.

The Greek government faces an unenviable political balancing act. The government needs to continue to implement reforms and prove to its creditors that progress is being made in order to receive the funds it needs to meet its maturing debt obligations. At the same time, it also needs to keep the support of its own party members and the wider Greek public.

Lessons from the 2011/12 Eurozone sovereign debt crisis suggest that negotiations on these issues still have a long way to go before they reach a long-term solution. Therefore, we think that businesses should once again review their plans for managing the possibility of Greece leaving the Eurozone. To assist with this, we have:

- updated the Greek exit scenario that we developed in 2011 in this edition of the GEW;
- outlined some potential triggers to watch out for over the next 6 months; and
- set out the three main channels through which a Greek exit could impact the wider Eurozone economy.

In the meantime, the Greek government must keep focused on its economic growth agenda, with the top priority being to bring down unemployment, which currently stands at around 26%. The real risk is that these negotiations will distract the government from the more important issue of kick-starting growth. Worse, the associated uncertainty could have an immediate adverse impact, particularly on consumer spending and investment growth.

A return to growth would not just benefit the Greek people, but could also pave the way towards finding a solution to securing Greece's place in the Eurozone.

Kind regards

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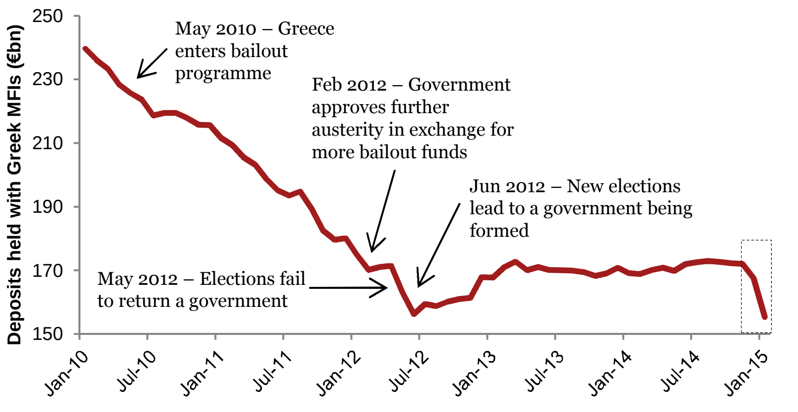
Fig 1: In January 2015, deposits in Greek monetary financial institutions (MFIs) fell by around €12bn, returning to the level they were at in the middle of 2012



Note: Measured as deposits of non-MFIs (excluding central government) held with Greek MFIs
Source: ECB

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Economic update: Eurozone GDP data shows a familiar trend

Germany ends 2014 on a high but France and Italy stumble over the finish line…

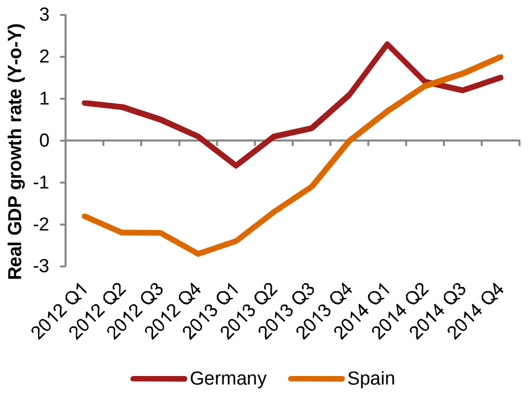
After disappointing growth in the middle of last year, Germany bounced back to post quarter-on-quarter (QoQ) growth of 0.7% in the final quarter of the year. However, consistent with recent form, the other two core economies lagged far behind. The French economy grew by 0.1% while Italian growth was flat, though this was a slight improvement on the previous two quarters when the economy shrank by 0.2% and 0.1% respectively.

…while Spain leads the charge of the peripheral economies

In contrast to their larger neighbours, Spain and Portugal both posted their fastest growth rates of the year. 2014 was a good year for Spain with its economic growth rate overtaking that of Germany when calculated in year-on-year (YoY) terms (see Figure 2). However, Greece entered into current events in a weakened position after its economy shrank by 0.2% QoQ in Q4.

In our main scenario we expect the Eurozone will be buoyed by low oil prices, a weak euro and the ECB's expanded QE programme, and that the current Greek crisis is resolved with Greece remaining in the Eurozone. We are projecting growth of 1.2% this year.

Fig 2: In 2014, Spain's YoY GDP growth rate overtook that of Germany



Source: Eurostat

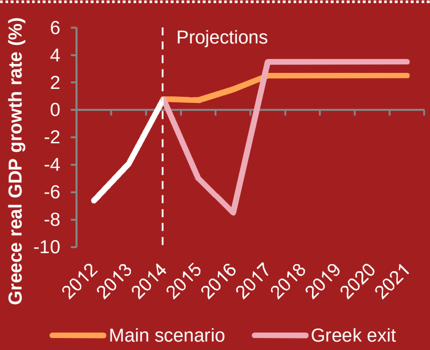
How might a Greek exit affect the domestic and Eurozone economies?

The threat of a Greek exit has not gone away

Despite the recent agreement to extend Greece's bailout package in the short-term, the lack of a long-term solution means that a Greek exit from the Eurozone is still a possibility (although not the most likely outcome in our view). Due to this, we have refreshed the original Greek exit scenario that we developed in 2011 to estimate the impact that a Greek exit would have on both economic growth and inflation in Greece and in the Eurozone:

- **Main scenario** – We assume that a deal is reached to extend Greece's bailout over the medium-term and, as a result, Greece remains in the Eurozone. As part of this deal, Greece continues on a path to structural reform.
- **Greek exit** – In this scenario, we assume that the respective governments fail to reach an agreement to extend Greece's bailout programme and as a result, Greece leaves the Eurozone in the third quarter of 2015.

Fig 3: A Greek exit could lead to a sharp recession and high inflation in Greece



Inflation rate (%)	2015	2016	2017-21 avg.
Main scenario	-1.3	0.3	1.4
Greek exit	6	8	4

Note: 2017-21 numbers are an average for the period
Source: PwC analysis

How might a Greek exit evolve?

In our Greek exit scenario, we assume that:

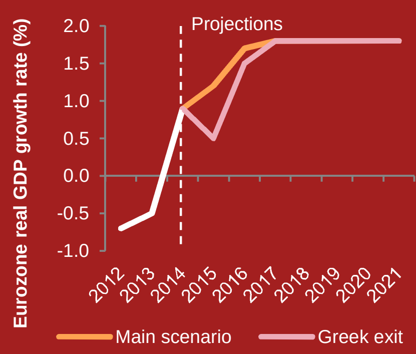
- the Greek government defaults on its debt obligations;
- capital controls are put in place to prevent the outflow of deposits from Greek banks to other Eurozone financial institutions; and
- the Greek government replaces the euro with a 'new drachma', initially introduced at parity to the euro but then allowed to vary in value.

Leaving the Eurozone could plunge Greece into recession

In practice, we would expect the 'new drachma' to depreciate almost immediately and inflation to rise sharply to around 6% on average in 2015. The depreciation would lead to a high inflationary environment with a medium-term inflation rate of around 4%, more than double the expected rate in the Eurozone.

In this exit scenario, the Greek economy shrinks in both 2015 and 2016, driven primarily by a sharp contraction in business investment and personal consumption, before returning to growth in 2017 (see Figure 3). Due to the exit occurring in Q3 of this year, the largest annual percentage change in GDP would occur in 2016.

Fig 4: The Eurozone could come through a Greek exit relatively unscathed



Inflation rate (%)	2015	2016	2017-21 avg.
Main scenario	0.1	1.4	1.4
Greek exit	0.5	1.2	1.4

Note: 2017-21 numbers are an average for the period
Source: PwC analysis

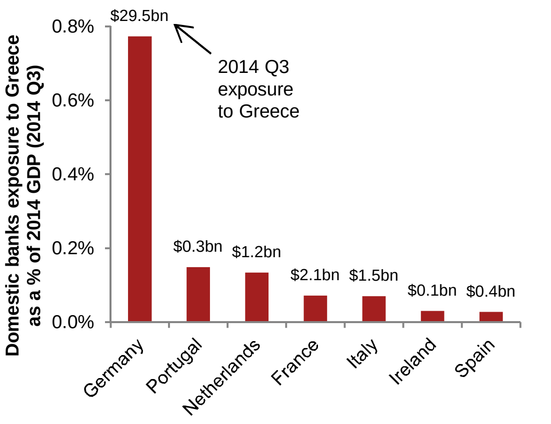
The effects of a Greek exit on the Eurozone would be much more muted

We would expect the Eurozone as a whole to survive a Greek exit relatively unharmed. If Greece leaves, the rest of the bloc are likely to strive to ensure that no other countries follow suit and therefore the currency union is expected to remain solid. The ECB's QE programme is also expected to provide short-term stimulus to the wider bloc.

This is reflected in the Eurozone maintaining positive GDP growth rates in 2015 and 2016 despite the Greek exit (see Figure 4). Both GDP growth and inflation are expected to move back towards our main scenario projections in 2016.

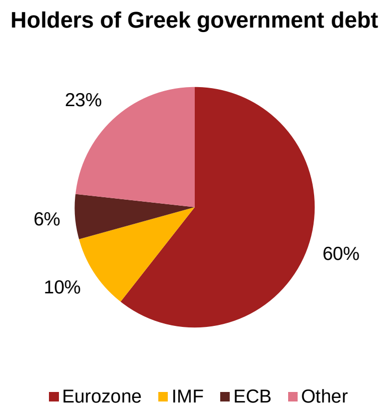
Two triggers and three channels – the numbers behind Greece leaving the Eurozone

Fig 5:The German banking sector has the largest exposure to Greece



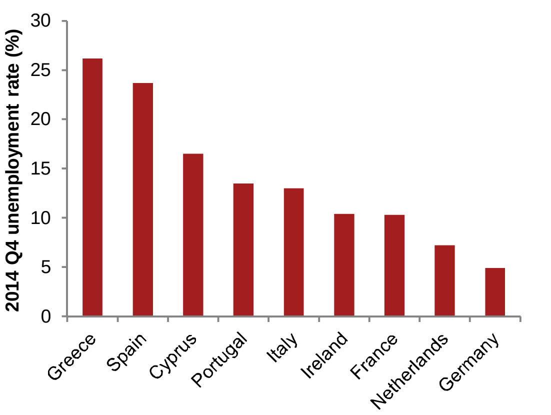
Note: Italy number based on latest data from 2013 Q3
Sources: PwC analysis, BIS, IMF

Fig 6: The majority of Greek government debt is held by official bodies and institutions



Source: Open Europe

Fig 7: The peripheral economies continue to feel the pain from the Eurozone crisis



Note: Greece data is from 2014 Q3
Source: Eurostat

Two main triggers could set the wheels of a Greek exit in motion

We think there are two main triggers which could result in a Greek exit:

1. **A Greek credit crunch** – Recent data from the European Central Bank suggests that deposits held by Greek monetary financial institutions (MFIs) fell to around €155bn in January 2015, similar to the level they hit in June 2012 (see Figure 1). Continued capital outflows could squeeze Greek banks' liquidity and make them ever more reliant on Emergency Liquidity Assistance (ELA) funding, which is expensive and limited.
2. **Implementation risks** – The Greek government has reached an agreement with other Eurozone governments to extend the current financing package for four months, subject to conditions relating to continued progress on economic reforms. According to the Greek Public Debt Management Agency, just under €40bn of Greek government debt matures in 2015. If the Greek government does not meet its reform commitments, then it will not receive the bailout money it needs to make these repayments, leading to a sovereign default.

Three channels through which a Greek exit could impact the Eurozone

There are three key channels through which a Greek exit could have an impact on the wider Eurozone:

1. **Banking sector** – Our analysis suggests that the Eurozone banking sector should be able to manage the impact of a Greek exit without severe consequences. The exposure of banks in the four largest Eurozone economies (Germany, France, Italy and Spain) to Greece has fallen from around $104bn in 2010 to $34bn. While the German banking system is the most exposed to Greece, this exposure equates to only around 0.8% of its GDP (see Figure 5). For the other economies, France, Italy and Spain, the direct exposure of their banks to Greece is less than 0.1% of GDP.
2. **Greek debt holders** – Figure 6 shows that around 60% of Greek government debt is held indirectly by Eurozone governments. If the Greek government defaults on its obligations, then that debt will be written off (at least in part). This could pose a risk to countries which already have a relatively large public debt burden. For example, a Greek exit could have negative implications for Italy, which guarantees around 20% of the Eurozone's bailout funds, and has a ratio of gross government debt to GDP of around 130%. Italy's exposure to Greek government debt is equivalent to around 2% of its GDP meaning a default could lead to a fiscal squeeze in Italy as the government attempts to fill the hole left in its finances.
3. **Unexpected contagion** – A Greek exit could also have effects outside the realm of economic data and financial statistics. It would likely add to political uncertainty as other countries may push for concessions on their commitments or it could set a precedent that sees other countries leave the Eurozone. For example, Spain and Portugal are both experiencing double digit unemployment rates (see Figure 7) and must hold general elections by the end of 2015. While the domestic consequences of Greece leaving the Eurozone could deter voters in other countries from seeking to leave the single currency area, there remains a possibility of surprising developments occurring in the Eurozone. In addition to this, a Greek exit could also call Greece's role in the European Union and NATO into question, spurring even more uncertainty.

At an aggregate level, Greece only makes up around 2% of the Eurozone economy, so a Greek exit is unlikely to have a big and lasting impact on the economic growth prospects of the area.

Projections: March 2015

	Share of 2013 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2014p	2015p	2016p	2017-2021p	2014p	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.7	3.0	3.3	3.0	2.6	2.2	2.4	2.5
Global (PPP rates)	100%		3.2	3.5	3.9	3.5				
United States	16.4%	22.4%	2.4	3.2	3.1	2.5	1.6	0.3	1.8	1.9
China	15.8%	12.7%	7.5	7.1	7.2	5.7	2.1	2.2	1.8	3.0
Japan	4.6%	6.6%	-0.0	1.1	1.4	1.3	2.7	1.4	2.3	1.9
United Kingdom	2.3%	3.4%	2.6	2.5	2.3	2.3	1.5	0.3	1.8	2.0
Eurozone	12.3%	17.1%	0.9	1.2	1.7	1.8	0.5	0.1	1.4	1.4
France	2.5%	3.8%	0.4	0.9	1.4	1.9	0.6	0.1	1.1	1.2
Germany	3.4%	4.9%	1.6	1.5	1.9	1.6	0.8	0.2	1.8	1.7
Greece	0.3%	0.3%	0.8	0.7	1.5	2.5	-1.4	-1.3	0.3	1.4
Ireland	0.2%	0.3%	4.3	3.3	3.2	2.5	0.3	0.4	1.0	1.5
Italy	2.0%	2.8%	-0.3	0.4	1.1	1.3	0.2	-0.1	1.8	1.4
Netherlands	0.8%	1.1%	0.8	1.4	1.6	1.9	1.0	1.2	1.1	1.3
Portugal	0.3%	0.3%	0.9	1.7	1.8	1.8	-0.2	0.1	0.8	1.5
Spain	1.5%	1.8%	1.3	2.2	2.2	2.2	-0.2	-0.3	0.7	1.2
Poland	0.9%	0.7%	3.3	3.3	3.5	3.2	0.2	0.1	1.7	2.5
Russia	3.4%	2.8%	0.2	-5.0	-0.5	1.9	7.8	15.0	8.0	4.3
Turkey	1.4%	1.1%	2.8	3.5	3.8	3.7	8.9	6.7	6.5	6.2
Australia	1.0%	2.0%	2.6	2.6	3.1	2.9	2.6	2.5	2.6	2.5
India	6.6%	2.5%	5.3	7.0	6.9	6.1	4.4	4.2	5.2	6.0
Indonesia	2.3%	1.2%	1.3	5.8	5.7	5.4	6.3	6.5	6.7	5.1
South Korea	1.7%	1.7%	3.4	3.5	3.7	3.5	1.3	1.5	2.2	2.9
Argentina	0.9%	0.8%	-0.4	0.1	3.1	2.1	25.0	25.0	-	-
Brazil	3.0%	3.0%	0.3	1.0	2.9	3.1	6.3	5.5	4.5	4.8
Canada	1.5%	2.4%	2.4	2.3	2.2	2.2	1.9	0.9	1.9	2.1
Mexico	2.0%	1.7%	2.3	3.2	3.5	3.9	4.0	3.2	3.5	3.1
South Africa	0.7%	0.5%	1.5	2.0	2.3	3.2	6.1	5.1	5.6	5.3
Nigeria	1.0%	0.7%	6.0	4.2	4.9	6.0	8.1	11.7	9.9	7.3
Saudi Arabia	1.5%	1.0%	3.6	3.2	3.0	4.4	2.7	2.6	3.0	3.4

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index released by INDEC. We will provide a 2016 and 2017-2021 inflation projection once a longer time series of data is available. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise during the middle of 2015	17-18 March
European Central Bank	0.05% (September 2014)	Rates on hold following decrease in September 2014	15 April
Bank of England	0.5% (March 2009)	Rate to start rising gradually from late 2015 onwards	9 April

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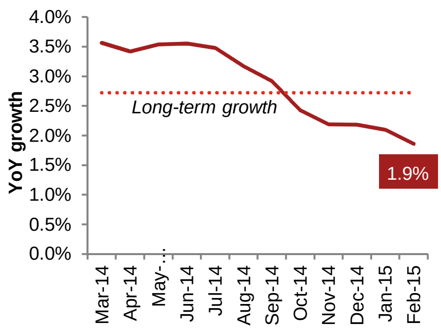
PwC's Global Consumer Index

GCI growth continued to fall last month, meaning that global consumer spending could take a further dive. Equity market performance weakened over the past month, however, global industrial production and consumer confidence have improved. Lower oil prices could translate into increased purchasing power for consumers worldwide, providing a boost to consumer spending later in the year.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

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