The Greek saga continues **13 February 2015**

This week Greek officials and their Eurozone counterparts failed to agree on a longer term solution for Greece's heavy debt burden. Time is ticking away to reach an agreement that suits all parties. Without such an agreement, Greece would soon be condemned to raise money on international capital markets in order to honor its financial obligations, a mission impossible now that market interest rates have shot up again. But Eurozone officials cannot afford to just stick with the current harsh conditions imposed on Greece. Chances that this stance will have unintended economic and political consequences further down the road are uncomfortably high.

Extremely severe budget cuts in recent years have taken a huge toll on the Greek economy with living standards more than 20% lower compared to 2008 and unemployment still above 25%. It is therefore little surprising that the snap elections held in January were won by a party that no longer accepts the binding constraints of the current bailout plan (Eur 240 bn in total). Syriza's leaders have made it crystal clear that they won't play ball if the rules of the game are left unchanged. Geek leaders have proposed several measures including a new debt restructuring plan (impacting the official sector, notably the ECB and other Eurozone countries), a revision to the planned privatization program, a review of the current tax system and structural reforms as well as smaller fiscal surpluses in the future. Meanwhile, Greek Finance Minister Varoufakis hopes to arrange a bridge loan in order to buy time. It's already certain that those requests will not be met in full as this is just not politically feasible. Earlier Greek proposals of swapping the ECB's debt holdings to perpetual bonds or linking debt repayments to GDP growth now seem to be off the table, at least temporarily. But on the other hand, Greek demands for more fiscal breathing room cannot or should not be simply waved aside, especially after years of severe budget cuts and economic pain. Doing so, would continue to place the bulk of the burden on Greek citizens. That would be unwise and almost certainly hasten the scenario of a Greek exit from the Eurozone. Several Eurozone leaders have claimed that this would be no big deal now that the ECB stands ready to prevent financial contagion to other countries in the periphery. But while the ECB has certainly proven that it is capable of doing so, we think this argument misses the point. The eurozone recovery is still extremely fragile and nothing assures that the economic reality in countries like Spain or Italy improves drastically in the coming years. A Greek exit for that matter would clearly demonstrate that the Eurozone project is not irreversible. That, in turn, opens the door for other countries to leave, giving rise to further self-fulfilling prophecies. This is clearly something that Eurozone leaders should keep in mind in current negotiations.

Discussions will continue after the weekend and the most likely outcome is still that Europe and Greece reach an agreement within the next few weeks. This should include some fiscal breathing room for Greece without which any improvement in economic sentiment is likely to prove short-lived. That said, despite huge savings efforts in recent years, two bailout programs and a private debt restructuring deal in 2012, longer term debt sustainability is still far from guaranteed. Therefore, another restructuring of Greek debt will still be necessary later on.