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Greek Crisis: The End Game and Beyond

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Summary

The three main protagonists in the Greek economic crisis, the Greek government, the IMF and the Eurozone partners ignored known lessons of how to deal with debt problems and committed policy errors that unnecessarily prolonged the crisis. This short note discusses the options for debt relief and restoration of creditworthiness at the end of the third bailout, which is soon approaching, and makes recommendations for Greek government policy that would promote viable, inclusive economic growth for the long term.

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Introduction

The end of the third bailout is rapidly approaching but the questions about the future of the Greek economy abound. In a book published in late 2017 (Michalopoulos, 2017), I wrote that the three main protagonists in the Greek drama- the Greek government, the Europeans and the IMF all made huge mistakes by ignoring the lessons of the past resulting in an unnecessarily prolonged and deep depression of the Greek economy. Have they learned their lesson or are they going to repeat the same mistakes? I also wrote that provided the Greek government adhered to the bailout conditions throughout, there is a need for a 'new deal' on the Greek debt. Did the Eurozone agreement reached on June 21 amount to such a deal or are we stuck in the same muddling-through mode that has characterized all previous agreements? The last part of this policy note looks at the important questions that the Greek government must address for the long-term viability of the Greek economy.

Lessons not Learned: The First two Programs

The Eurozone

The Greek debt problem was not without precedent. In the 1980s and 1990s many developing countries, some with very large economies—albeit with slightly lower per capita incomes had faced similar problems and had sought assistance from the international community. A basic condition for a successful program was a PSI (Private Sector Involvement), of such magnitude as to restore the capacity of the reforming country to service it over time, i.e., it was to meet the debt sustainability test. The original Greek bailout did not involve a PSI because of concerns about its implication for contagion as well as the health of the French and German banks involved. There was a PSI in the second bailout, but in the meantime the private sector banks were able to unload about 40 billion euro of Greek debt and another 10 billion euro while the second bailout was being negotiated, thus forcing a greater burden of the haircut on domestic banks, which had to be recapitalized, as well as on Greek pension funds.

Unlike most emerging countries benefiting from the Brady schemes in the 1990s, who were only able to obtain support from the IMF and the World Bank, Greece, as a member of the Eurozone could ask and did obtain substantial financial assistance from its Eurozone partners. This resulted in a substitution of official for private debt without significantly reducing the overall debt burden. It also made further debt reduction politically more difficult and increased the politicization of the reform packages as well as the complexity of reaching agreement between the Eurozone, the IMF and Greece.

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The IMF

In all previous successful cases of adjustment there was invariably an IMF program to restore macroeconomic balances, usually involving tight monetary policy, a reduction in budget deficits and overall absorption, which resulted in temporary contraction of output and reduced employment. There were also structural adjustment conditions aimed at increasing competitiveness and shifting resources to the tradeable sector. The conditions attached to the programs were expected to be few, measurable and focused on important aspects of reforms.

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The IMF programs under the first two bailouts did not take into account the known and knowable facts about the Greek situation in making the projections of recovery and debt sustainability. There were at least three problems: first, the projected impact of the deficit reduction on GDP was much smaller than the one actually observed; second, the impact of the internal devaluation on real output was equally underestimated; and third and most important the conditionality attached to the program was too detailed as well as focused wrongly if the objective was to shift resources to the tradeables' sector- especially more exports. There was no way that the conditionality which focused on the labor market and labor costs could have done much to improve Greek merchandise exports through internal devaluation: many Greek exports are capital intensive or dependent on immigrant labor whose wages are minimally affected by the formal labor market reforms. To its credit, the IMF has recognized some of these weaknesses recently (IMF, 2017 and IEO, 2016). Unfortunately, they were not taken into consideration in the second IMF program in 2012.

The Greek Government

The most important lesson from the debt and adjustment programs of the 1980s and 1990s was that government ownership of the reform program was critical to its success. Similarly, important was the government's ability to convince public opinion about the necessity of the proposed reforms.

Early on and throughout most of the first Stand-By Arrangement (SBA), there was no questioning of the Greek government ownership of the program of fiscal adjustment. Any government which reduces a budget deficit by more than 5% of GDP as the Greek government did at the time must have been committed to the program. This was especially the case with the Ministry of Finance and the Prime Minister. While not all aspects of the fiscal reform were implemented on time as the situation in the Ministry and related agencies was truly chaotic, the bulk of the benchmarks were met (Papaconsantinou, 2016). Major problems continued however, with tax evasion. The same pattern continued with the second program. And as had happened in many developing countries in the 1980s and 1990s, problems arose with the implementation of the reforms by the other Ministries. Regrettably, the early failures in structural reforms undermined confidence in the government's commitment and resulted in a 'short leash' detailed conditionality later on.

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The successive governments also failed in 'selling' the program to the public—partly because the main Ministries involved in the program could only speak about the hardships the program would entail. There were a few voices, arguing that all the measures advocated by the Troika had to be undertaken, irrespective of whether they were part of the onerous "memorandum" because they made sense and would strengthen the Greek economy in the long run. But these voices were drowned out by the fierce political opposition both by the parties of the Greek Left and those of the Greek Right. There was no consensus for reform in Greece at that time or later.

The bottom line is that all three major participants in the first Greek bailout failed to heed the lessons of the past. The result was a second bailout with some of the same flaws which only partly improved the situation; and the saddling of the Greek economy with a public debt whose servicing is causing a major constraint on future growth.

The Learning Curve of the Third Program

All three protagonists learned some things from their experience of the first two programs. The IMF correctly decided that it was not going to participate in the program as the Greek debt was not sustainable. It was invited and participated actively in the monitoring of the program's conditionality.

The Eurozone partners provided assistance on much softer terms than under the punitive ones of the earlier programs as well as provided some debt relief on the earlier assistance. This was done in the context of a program characterized by continued very tight fiscal targets and detailed conditionality with a very short leash: assistance was tranched quarterly and there was an excruciating number of detailed conditions about all aspects of economic and social policy that had to be met before a single euro was disbursed.

In my twenty years at the World Bank I had reviewed dozens of 'memoranda' of programs in developing countries and the former Soviet Union, none of which contained such a short leash approach. Indeed, as many international accords, such as the Paris High Level Forum on Aid Effectiveness in 2005 had stated, this is precisely the kind of conditionality that should not be imposed as it worsens the climate of donor-recipient collaboration that is necessary for program success. In Greece it was originally imposed because the judgement had been made, correctly, that the implementing institutions were weak. Later on, it reflected the total lack of confidence in the successive governments' commitment to reform. Despite everything, as we shall see later, it seems to have worked, at least in the short run.

The first Tsipras government opened its tenure with six months of disastrous policies highlighted by the Varoufakis shenanigans which set back the economic recovery for close to two years and left Greece with the residue of capital controls on banks which are still in place. But following the famous somersault, the second Tsipras government, to its credit, steadied itself and met all the detailed conditionality and more than met the tight fiscal targets. Not that the government showed much enthusiasm for the programs, especially privatization, that it was asked to implement. In an infamous incident in the summer of 2016 the agreement with COSCO for the privatization of the Pireaus port was submitted to the Parliament for final approval. At the last minute and without consulting with the Chinese firm, the Minister in charge introduced certain changes detrimental to the firm. The timing was extremely unfortunate as that very day Tsipras was about to meet with the top of China's government in a formal visit to Beijing. Following the Chinese firm's loud protests, the changes were withdrawn and the legislation passed.

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Supported by record tourism receipts—Greece being an island of stability amid the Middle East chaos, the economy has hit bottom and started to grow hesitantly in 2017 and 2018. But the current understandings regarding debt servicing and fiscal targets in the near future, combined with the massive amounts of non—performing loans in the banking system are condemning the Greek economy to a low-level equilibrium with few and uncertain growth prospects. Writing in the summer of 2017, I said "The recent deal with the Eurozone partners committing Greece to maintain a 3.5% primary budget surplus means continued fiscal stringency until 2022 and beyond. The budget constraint exists because of the need to maintain a primary budget surplus in order to meet debt obligations. This constraint has resulted in the establishment of an equilibrium at low levels of capacity utilization with no growth and a vicious circle: incomes are growing very slowly, if at all; as a result government revenues stagnate, the debt has to be repaid and the only way to do this, given large expenditures on defense (other than the US, Greece is the NATO country that devotes the largest share of its GDP to defense, more than 2%), is to squeeze expenditures resulting in stagnant incomes and so on. Pensions and investment have borne the bulk of the budget cuts. I suspect that pensions cannot be squeezed much further without causing even more social unrest." (Such unrest of course did happen recently when further cuts in the 2019 pensions were announced). "A New Deal is needed for Greece without a long protracted and acrimonious negotiation by the summer of 2018" (Michalopoulos, 2017, p.275).

A New Deal?

The New Deal that I called for last year was a simple holding action that would have resulted in putting the Greek crisis behind and permitted modest growth until such time as a major strengthening of the Eurozone was in place. It would have required actions by both the Eurozone and Greece. On the part of the Eurozone, it would have required a substantial debt reduction to give an unmistakable signal to the markets that the Greek debt is sustainable. Greece would have had to adhere to the detailed conditionality of the current program—which it has done, as well as the fiscal constraints that it has agreed to for the next two years. But it would have had much greater fiscal leeway thereafter. The government should also have committed to much needed reforms in many areas, notably to stimulate domestic and foreign private investment, especially focused on merchandise exports and tourism, as well as to a reform of the education system.

In the long term the only viable solution for a country like Greece, or Italy, is a strengthening of the Eurozone via the known but very difficult changes that everybody agrees that are needed such as a unified fiscal policy or something like it, common deposit insurance and possibly issuance of euro-bonds. A viable euro would require adjustment by both the surplus and the deficit Eurozone countries. In the last decade,

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countries in the periphery, Greece, Italy, Ireland, Portugal and Spain have all reduced their current account deficits as a per cent of GDP—some have turned them into surpluses. By contrast Germany has increased its current account surplus from 4.6 % of GDP in 2005 to 8.4% in 2015. That year, while Greece was struggling mightily to achieve an internal devaluation, Germany through its own macroeconomic policies achieved a further undervaluation of its real exchange rate by 10-20% compared to 5-15% in 2014 (IMF, 2016 p.7).

In a currency union, since exchange rate and monetary policy adjustments are impossible for a single country, the only remaining tool is fiscal policy. Fiscal policy adjustment should be balanced and fall at least in part on the surplus countries, not only the ones in deficit. An IMF report on Germany cautiously states "a looser fiscal position than currently envisaged through 2016-2021 would be appropriate. This would also modestly reduce the current account gap (surplus) (IMF, 2016 p.10)." Unless Germany and the other surplus countries are prepared to adjust their policies to some degree, the euro will not survive and/or some countries including Greece will leave it as their continued participation will demand indefinite stagnation. At present, a major fixing of the euro is impossible because there is a public perception in Germany, Netherlands and a number of other Eurozone members that it would involve their own taxpayers paying for costly bail outs of the bad policies of the "South".

After protracted negotiations, agreement was reached in the Eurogroup meeting of June 21 on debt relief and future Greek policies. Does the agreement amount to the new deal needed for Greece to restore its creditworthiness as well as a path to long term sustainable growth? Or are we stuck in the same muddling through process characteristic of the last bailout?

The End Game

The Eurogroup meeting reached decisions on three sets of issues that would affect the short-term prospects for Greece borrowing again in the private capital markets: how much to reduce Greek debt, what, if any, conditionality would be attached to the reduction and who will monitor the conditionality.

Debt Relief

It would seem that everybody except perhaps Germany agreed that sustainability of the Greek debt requires debt reduction, not necessarily in the stock of debt but at least through the lengthening of its maturity. Recall in this connection that last year's agreement said that debt sustainability would require adjustment in the maturity of Greek debt ranging from 0-15 years. Consistent with this position, Germany argued for a long time that no lengthening of the maturities is needed at all. The IMF argued for a 10 to 15-year extension for the bulk of the debt. In the end it was agreed to extend for 10 years the maturity and interest payments on the EFSF (European Financial Stability Facility) debt which accounts for about 30% of the overall Greek debt burden. This was apparently provided without additional conditions (Council of the EU, 2018).

In addition it was agreed to: (a) abolish an interest rate increase associated with the second bailout; and (b) return to Greece the profits on Greek bonds held by the ECB, other Central Banks and the ESM- upwards of 7 billion euro- in several semi-annual installments starting in 2018 and ending in 2022. These benefits were conditioned on Greece's implementing a series of measures detailed in an annex to the agreement. Furthermore, it was stated that the debt situation will be reviewed again in 2032(!) and that in the meantime if there is an 'unexpectedly more adverse scenario' a 'contingency mechanism' could be activated (Council of the EU, 2018).

The agreement fell considerably short of what the IMF thought was needed. As a result it has refused to certify that Greece's debt is sustainable, which poses a problem for Greece's return to the capital markets. There are obvious uncertainties in judging long term debt sustainability but the recent Eurogroup decisions fall short of the clear and loud message that the markets were looking for. The conditionality attached to some of the measures creates further uncertainty. In sum, the agreements reached on debt relief fall far short of the 'New Deal' needed to propel Greece to credit worthiness and future growth. They are more in keeping with the muddle through approach that has characterized all relief measures so far.

Conditionality and Monitoring

The conditions attached to some parts of the support package are quite similar in range and scope to the conditions attached to previous bailouts. Nothing seems to have changed from the short leash approach of

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Globalization will impose additional challenges.

the past. There are two basic problems with the conditions agreed: first, the fundamental fiscal scenario that has been agreed of 3.5% budget surplus through 2022 and an average of about 2% until 2060(!) is destined to condemn Greece to slow, if any, growth indefinitely. It is not realistic and it is hypocritical to pretend that it is sustainable. As argued earlier the only long term solution is a reform of the euro that will create a greater balance in the adjustment of surplus and deficit countries together with a much more substantial debt relief.

Second, the conditionality continues to be absurdly detailed. One of the conditions requires that the Greek government ensure that the Independent Authority of Public Revenue has exactly 13,322 positions by mid-2021; and another that the government establish 240 health centers by mid-2020 (Council of the EU, 2018, Annex). One wonders whether several hundred million euros will be held up from being paid if the government fell short in achieving these precise goals. Regrettably, none of the conditions dealt with measures that would ease the way of doing business, a key constraint in increasing foreign investment (see below). The EU Commission suggested recently that there would be flexibility in the implementation of the agreement only to be contradicted by other EU institutions. The whole issue is a sad reminder of the total lack of trust that the 'institutions' continue to have in successive Greek governments over almost ten years.

The main question on monitoring has to do with the IMF involvement. IMF participation has been needed not because of Greece's short-term financing needs, but primarily for the IMF imprimatur on debt sustainability. This is not forthcoming at present. Instead the IMF committed itself simply to participate in the post-program surveillance alongside the European institutions. This will happen in the context of the Enhanced Surveillance procedure of the European Commission that will involve quarterly reviews of the Greek government's performance in meeting the agreed conditions.

Beyond the End Game

Consistent with its wish for a clean end of the 'memoranda' and no more conditionality, the Greek government has been accumulating a financial buffer, presently at around 24 billion euro, by exceeding the fiscal surplus targets, in part by underspending on investment. At the end of the day, it has failed to avoid conditionality for part of the relief provided and the Eurozone partners were not sufficiently generous in providing debt relief to ensure access to the capital markets. Thus, the cash buffer is essentially protection against future difficulties in accessing these markets. Arguably, the conditionality attached to the program should also enable the ECB to continue to provide a 'waiver' that reduces the cost of borrowing by Greek banks and continue purchases of Greek bonds without Greece having to resort to the establishment of a precautionary credit line through the ESM

How the third program concludes will affect Greek economic prospects in the next several years. Most decisions about this were outside Greek government control. But longer-term prospects depend primarily on Greek government policy and the vitality of the Greek private sector. To this end, the government has put together an economic plan. An important recognition of the plan is the need to give high priority to increasing both public and private investment. The most striking statistic of the past eight years has not been the decline in GDP but the spectacular decline in investment - both public and private. By contrast, consumption fell less, since households continue to use up their savings. At 75%, the decline in investment is the largest by far of all the countries that suffered the kind of shocks that Greece suffered (Gournichas et.al 2016). How can labor productivity grow under these circumstances?

The government is proposing to establish a National Development Bank, a quaint proposal harking back to the 1980's when many such banks were established in the developing world. In principle there is nothing wrong with such institutions. Experience however, has shown that they are prone to corruption and inefficiencies in countries like Greece with a tradition of political party patronage. Besides, the European Investment Bank does precisely the same thing; and there are ample funds provided by the EU programs which remain unutilized. Whatever the institutional arrangements, it is important to channel additional investment to the tourism sector, Greece's 'heavy industry' and to merchandise exports in general, as part of the needed reorientation of Greece's economy.

Government efforts in this area will not succeed unless the banking system is revitalized through the working out of the massive amounts of non-performing loans. A fundamental change is also needed in the bureaucratic rules and regulations affecting business practices. Greece ranks 67th in the World Bank's global index of the ease of doing business, below all its Balkan neighbors, Cyprus and Turkey and below all EU members except Malta. Something has to be done soon!

Globalization will impose additional challenges. There is a need to establish active labor market programs, not to reestablish rules that limit labor mobility as the government is apparently contemplating. Such programs demand early and frequent engagement with displaced workers, requiring them to participate in interviews with employment counselors, formulate individual plans, accept offers of suitable work and attend training programs, if necessary. This is best done on the job and involves establishing strong ties between the programs and the private sector.

The education system is a mess. There is need for education reform that meets a key challenge of the 21st century: equipping individuals with skills which increase flexibility in getting jobs in the face of rapid technological change which destroys jobs.

There are more things that need to be done. For example, the justice system is sclerotic involving long delays adversely affecting the ease of doing business. The point is different: while in the end game of the third bailout the 'Institutions' held all the top cards, in the longer run the Greek government has the primary opportunity and responsibility to pursue the kind of policies that are needed for inclusive growth.

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