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Past Mistakes and Current Joint Responsibilities: the Greek debt crisis

By Yuefen Li

With the Greek debt crisis raging on, another round of blame exercise has started. It is not really unhealthy to do so, as with it comes the responsibilities for fixing the crisis. Looking back over the years since Greece joined the euro zone in 2001, it would be correct to say that the Troika -the European Central Bank (ECB), the International Monetary Fund (IMF), the European Commission (EC) – as well as the Greek government all have had their share of misjudgments, illusions, technical errors and political prejudices, though some parties more than the others.

While the world has been lamenting the asymmetric economic recovery from the 2008 global financial crisis, Greece is a country which has been in severe economic depression for the past five years, except for a brief period in 2014, after accepting the rescue package by the Troika in 2010 and, with it, the imposition of brutal austerity measures as conditionality for getting the financial lifeline. In the last week or so, the Republic has been thrown into a full blown financial and humanitarian crisis. On 28 June, the ECB froze its Emergency Liquidity Assistance (ELA) to Greek banks. As the country no longer has access to the international capital market and the banks have been kept afloat by ELA even before the ECB freeze, the triggering of panic among the population by the freeze is understandable. Following the "sudden stop", there was a severe bank run. ATM machines were emptied and armed personnel have been positioned beside ATM machines and in front of banks with long queues of people waiting to withdraw money. The government had to impose capital control. Banks were shut down. Depositors were given a stringent €60 rationed money withdrawal per day. The impact of capital control will be fully manifested in the coming days and weeks as imports would be affected and resultant shortages of daily necessities would take their toll on the population. As the SDR 1.2 billion repayment (about EUR 1.5 billion) due by Greece to the IMF had not been paid by 30 June 2015, Greece is in arrears vis-a-vis the IMF. It seems the financial and economic situation cannot be worse for Greece.

How has Greece come to such an economic plight? What has gone wrong? These are the questions that deserve to be answered and studied in order to find a way out.

Reckless Lending by Eurozone Countries and Reckless Borrowing by Greece after Greece Joined the Euro

Greece joined the euro in 2001. Though its economic fundamentals were certainly no comparison with Germany, the capital market priced the Greek risks almost at the same level as that of Germany. The Greek national debt rocketed from €168 billion in 2004 to €262 billion in 2009 and the debt to GDP ratio from around 95% in 2002 to 145% in 2010. Eurozone countries held over €200 billion of this debt by 2009.[i] As Paul Krugman explained, with the interest rates converged across the Euro zone, Greece, a formerly high-interest-rate country, went on a borrowing spree which was largely financed by banks in Germany and other traditionally low-interest-rate euro zone countries.[ii]

IMF and ECB Circumventing Rules to Put Off Greece Debt Restructuring

By 2010, many economists were of the view that Greek debt was not sustainable. With credit rating agencies repeatedly downgrading Greek's long-term debt, the spread between the yield on Greek and German bonds shot up to 469 basis points, pushing up the cost of borrowing and debt re-servicing. However, the ECB was of the view that a debt restructuring would cause wide spread contagion in the Eurozone. In addition, default of a developed country was also considered hard to swallow. Although the IMF considered Greek debt had high risk of unsustainability, it went along with the ECB and the EU.

In May 2010, the troika approved a €110 billion financing package to help Greece. The IMF contributed 26 billion of SDR, the greatest ever credit exposure to a single country. In doing so, the IMF circumvented two IMF principles: 1.The IMF loan to Greece was about 26 times the Greek quota in the IMF. The maximum amount that a country can borrow from the IMF, its access limit, is typically in line with the country's IMF quota. The size of the loan to Greece was unprecedented in the IMF lending history and such magnitude had never happened to a developing country; 2. When assessing debt sustainability, the IMF admitted that there were significant uncertainties for debt sustainability and it was difficult to state categorically that debt was sustainable with a high probability. However, "while risks regarding debt sustainability are undeniably high, the Fund's support is nevertheless justified" [iii]. Further to the Greek package, the IMF amended its "exceptional access framework" by introducing an extra factor, namely "a high risk of international systemic spill overs", mainly with the purpose of justifying the lending to Greece. With widespread criticism and benefiting from hind sight, the IMF tried to remove this systemic risk factor revision from its lending principles in 2014, however, some major countries were against the removal of it.

Even though the IMF's financial contribution to the rescue package is less than one third, it did lend its credibility and technical expertise to back up the package. It sent an important message to the market. In addition, the IMF participation in the rescue package has shown once again the lack of consistency in standards and even-handedness in the IMF loans, which has been a concern at times.

For the ECB and EC, from 2009 onward, they actually went around to lobby against the idea of debt restructuring. Their obvious preference for kicking the can down the road even when the general assessment of the Greek debt was unsustainable was the main determinant for putting together a rescue package. Even though the ECB was bound largely by the no-bailout clause of the Lisbon and the Maastricht Treaties, like the IMF, it decided to navigate around the rules in 2010. The ideological shackle that a developed country could also have unsustainable debt which needs to be restructured could also have played a role in this decision.

By hind sight, an earlier debt restructuring could have mitigated many problems, especially the brutal austerity and the massive migration of Greek private debt into public sectors.

Socializing Greek Debt to Save Financial Institutions of Core Eurozone Countries

Most of Greece's debt now is public. But in 2010, most of the debt was private. In the two years before Greece's technical default and debt restructuring in 2012, the government continued to service the debt largely with the rescue money from the troika. This actually gave sufficient time for practically most private creditors to reduce their exposure to Greek debt to zero. Some economists thought the debt restructuring came too late and too little, meaning most private sector debt already retired or changed hands.

When debt restructuring finally took place in 2012, Nouriel Roubini noted that [iv] "*private creditors got a very sweet deal while most actual and future losses have been transferred to the official creditors.*" After the debt restructuring, there was an increase of €130bn in the debt Greece owed to official creditors. The official sector during debt exchanges spent tens of billions of Euros buying bonds at par while the market value was 25 to 30 percent below par, with the knowledge that the reprofiled bonds would most likely not be sustainable as the debt to GDP ratio of Greece was at 140%. In this way, privately held Greek debt actually showed up on the balance sheets of the Eurozone governments, particularly the major ones.

These "sacrifices" apparently were not mainly for the sake of the Greek government and people. The reason for the huge socialization of the Greek private debt was to a large extent to protect the major financial institutions from core euro zone countries like Germany and France. These institutions started to develop huge exposure to the Greek debt, especially sovereign debt, after Greece's accession to the euro zone. Many papers have examined where the troika's bailout money has gone. Some speculated that only 11% directly financed activities of the Greek government and a large part was spent on bailing out large banks from core euro zone countries.

IMF's Technical Error and Resultant Excessive Austerity for Greece

With a debt to GDP ratio increasing from 140% at the start of the bailout program of 2010 to 177%, an overall unemployment rate rising from 13% to 28% and youth unemployment rising to almost 60 percent and the GDP bout 26% below the pre-crisis peak level, it is difficult to rate the harsh conditionality as success. The key elements of the 2010 reform package [v] were based on the IMF technical analysis. Fiscal consolidation was excruciating, totaling 11 percent of GDP over three years —on top of adjustment already under way. The target was to get the general government deficit under the 3 percent level by 2014 (compared with 13.6 percent in 2009). With this target**,** government **s**pending measures were expected to save 5 ¼ percent of GDP through 2013. Pensions and wages would be reduced and frozen for three years. Detailed pension legislation reform was introduced.

The subsequent economic recession and uncertainties in Greece was contrary to the expectations of the designers of the rescue package. The very honest Chief Economist of the IMF at that time wrote respectively in 2012 and 2013 in the *World Economic Outloo*k, an annual IMF report, and a co-authored paper entitled *Growth Forecast Errors and Multipli*ers to point out that the disappointing economic activities of some countries going through fiscal consolidation ran counter to their original forecasts. The main findings of these two technical pieces were that "*the multipliers used in generating growth forecasts have been systematically too low".* This means that IMF forecasts have been consistently too optimistic for countries that pursued large austerity programs. Therefore, drastic fiscal consolidation with tax hikes, spending cuts, wage and pension cuts like what Greece had would do more damage to those economies than expected. The graphs in the study showed very clearly the negative effect on the GDP growth on Greece. This actually explains the doom of the illusion that Greece could grow out of its debt problem through fiscal consolidation. Instead of earning more money through GDP growth to service debt, the economy plunged into recession. The money saved from the higher taxation and spending cuts including wage cuts would not be sufficient to service debt. No wonder the Greek economy continued to shrink years after the implementation of the IMF program. As for increasing unemployment rate, the studies stated that "forecasters significantly underestimated the increase in unemployment and the decline in domestic demand associated with fiscal consolidation".

Nevertheless, the technical error in the modelling is the determinant for the degree of fiscal consolidation and other elements of the programme which the Greek government has been requested to implement faithfully. Deviations from the programmed target would lead to non-disbursement of rescue funds, keeping the Greek government at a very short leash. There is very limited sovereignty left to the government, no monetary policy autonomy at all, no fiscal policy autonomy, no power to determine wage policy, no space to determine pension policy and even no autonomy to determine military expenditure.

Sharing Responsibilities and Giving Greece a Fresh Start

The Greek government has its share of blame for leading the country to today's economic collapse. It went on irresponsible borrowing after it cooked the books to enter into the Eurozone. They knew better than others that the debt was unsustainable. All the same, it was reluctant to restructure its unsustainable debt. The government also accepted the huge loans and the conditionality with it. However, the troika is the demander right now as if all the blame should have gone to the Greek government only. This is a time which requires joint responsibilities, in particular when the Greek population has suffered immensely and will not be better off in some years to come.

The expectation of reviving economic growth with fiscal consolidation has proved to be an illusion. Even though debt maturity and interest payments seem to be in good shape over the long term, the three years between 2015 and 2018 have huge financing gaps mainly because of concentrated amortisation and interest payments coming due. The latest IMF estimates are at more than 50 billion euros. Therefore there is no hope of Greece growing out of debt crisis without significant debt relief.

GDP growth is forecasted to be at zero percent for 2015 and the economic recession seems difficult to dispel. It is hard to imagine debt refinancing capabilities of the government could meet the financing needs. As the ECB, the EC governments (EFSF) and the IMF together owe almost 83% of the Greek debt and since all have had their share of mistakes contributing to the current Greek plight, they should also share the responsibilities in pulling Greece out of its debt overhang. Not doing so, would see poverty rising and the Greek economy further contracting.

The IMF turned down flatly the Greek demand for postponing the payment of loans coming due. However the IMF Articles of Agreement do allow member countries to delay payments for a maximum of 5 years if a 70 per cent majority of the total IMF voting power would support such a deferred payment. Whether or not Greece would be able to win 70 per cent vote is another issue, but not to give Greece the chance of going through the process seems to be unfair. On 4 July 2015, one day before the Greek population went to cast their votes on the referendum on the new deal, the IMF had a new posting on its official website, *Nine Key Questions on Greece.* Question 4 clearly states that "*A member country can request a postponement".* Though this was belated, it did indicate Greece had this option, contrary to some signals given by the IMF before. The Greek government could consider putting forward the request for the favorable consideration of the IMF Board of Directors.

In view of the economic recession in Greece, and in order to promote country ownership of the restructuring program, it is of paramount importance that the IMF, the ECB and the EC review carefully the main elements of the conditionality together with the Greek government and be sensitive to the difficulties faced by Greece and try to see and introduce needed flexibilities. To let the previous loan program expire and have a new loan program may be considered as reasonable. In particular, the feasibility of achieving a primary surplus of 4.5% of GDP in 2016 could be reviewed, taking into consideration the effect of the multiplier in the calculation of fiscal consolidation on economic growth.

To pin hope on Greece to grow out of the current debt overhang by itself may not be feasible. There are two options ahead. One is to provide financial assistance at whatever cost for a long period of time. This will have to be of significant amount which can bridge debt servicing in the coming few years and also can increase investment in productive sectors to allow economic growth. The other option is to have another round of debt restructuring including haircut and maturity extension which could provide meaningful debt relief. Whatever the case, Greece will have to go through needed structural reform with the aim of improving competitiveness.

The resumption of the provision of ELA by the ECB would be important to keep the Greek banks liquid and maintain the normal banking functions.

The solutions and way outs would require almost all the major elements included in the reignited international debate on an international debt workout mechanism. One wonders why not much progress has been made even relating to the major principles for debt restructuring when two countries, Greece and Puerto Rico, are facing acute debt servicing difficulties in the same week.

Endnotes:

[i] IMF Country Report No. 09/244, Greece: 2009 Article IV Consultation, August 2009.
[ii] Krugman, P. (2011, January 12). *Can Europe be saved?* Retrieved from http://www.nytimes.com/2011/01/16/magazine/16Europe-t.html?pagewanted=allKulish .
[iii] IMF Country Report No. 10/110, Greece: Staff Report on Request for Stand-By Arrangement, May 2010 (pages 20 and 28).
[iv] N. Roubini, *Greece's private creditors are the lucky ones*, Financial Times, March 7, 2012. http://www.ft.com/cms/s/0/f0f0708e-679d-11e1-b6a1-00144feabdc0.html#axzz3k7MQABsY
[v] Europe and IMF Agree €110 Billion Financing Plan With Greece, IMF Survey on line, May 02, 2010, http://www.imf.org/external/pubs/ft/survey/so/2010/car050210a.htm.

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