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The third Greek bailout: An assessment

The immediate crisis has been resolved, but has the pact with the European Council ensured Greek solvency over the medium to long term?

Photo: Reuters

On 13 July, the European Council reached an agreement in principle on a third bailout for Greece in five years. The agreement was hammered out over 30 hours of back-to-back meetings, first of finance ministers of the Eurogroup and then the 19 European Union (EU) heads of state. Much work remains to be done over the next few weeks, especially by way of prior actions by the Greek government, pending finalization of a memorandum of understanding.

Assuming that happens, Greece could receive financial assistance of up to €86 billion from the European Stability Mechanism (ESM) over the next three years. To tide over the interregnum, the creditors will provide bridge financing of up to €7 billion by 20 July and another €5 billion by mid-August. The agreement also enables the European Central Bank to resume emergency lending to Greek banks that have more or less shut down operations for the last two weeks due to shortage of funds. So the immediate crisis has been resolved, but has the agreement ensured Greek solvency over the medium to long term?

The main features of the Greek debt crisis are quite well known. When Greece joined the European Union (EU) in 2001, the then government fudged the GDP and debt data to meet the required conditions of the EU’s Stability & Growth Fund, reportedly with the help of a powerful Wall Street investment bank. However, nobody scrutinized the data too closely. Over the next seven years, Greece spent its way to prosperity on borrowed money. It received large loans from German, French, Greek and other private banks with little due diligence.

The impact of the 2008 global financial crisis laid bare the truth of Greece’s fragile fiscal condition. By 2010, the Greek government could no longer meet its servicing obligations on sovereign debt of about €300 billion, 130% of its GDP. Moreover, with a fiscal deficit of 15% of GDP, the debt stock was growing at 12% per year.

Had the government and the banks been left to sort out their mess, the private banks would have taken large haircuts but cleaned up their balance sheets, while the Greek government would have been forced into fiscal prudence to pay its own way. Instead, the troika (European Commission, European Central Bank and the International Monetary Fund) stepped in to ‘share the burden’ with a €110 billion bailout package over a three-year period. The same burden-sharing approach was followed for a second bailout package of €130 billion that followed in 2012, supplemented by a further IMF loan of over €8 billion to cover the period up to March 2016.

On both occasions the private banks took partial haircuts, while the Greek government undertook to pay the balance of its debt obligations using fresh loans from the troika.

While the loans were largely used to repay debt, Greek citizens were now suffering the pain of austerity measures coupled with very high unemployment since the bailouts were given against adjustment agreements requiring severe spending cuts, tax reforms, privatization, etc.

The spending cuts notwithstanding, the government failed to get its fiscal house in order because, among other things, it failed to meet its tax and non-tax revenue targets. Hence the need for a third bailout.

Meanwhile, after suffering years of high unemployment and austerity, Greek voters elected a new leftist government of the Syriza party, led by Prime Minister **Alexis Tsipras**, that promised to end the austerity programme. For months, the new government engaged in acrimonious negotiations with the troika for a bailout without the harsh austerity programme. However, the creditors not only wanted a tough adjustment programme but also conditions to ensure Greek compliance since many components of the earlier adjustment programmes had not been implemented. A sub-group of countries, led by Germany but also including the Netherlands, Belgium, Finland and Slovakia among others, took a particularly hard line. They were against any debt restructuring and also demanded that and any fresh loan should be given exclusively for repayment of debt. Note in this context that €243 billion out of Greece's estimated sovereign debt of €323 billion is now held by other EU governments, the largest creditor being Germany, which is also the largest shareholder in the ECB.

Faced with such a hard line creditor position, the Tsipras government withdrew from the negotiations, announced a referendum on the creditors' terms, and defaulted on an IMF repayment at the end of June, triggering two weeks of chaos. All assistance to Greece stopped immediately, the banks virtually shut down operations and the Greek economy started grinding to a halt.

In the 5 July referendum, over 60% of voters voted against the creditors terms, but within two days, Tsipras did a U-turn, seeking and getting parliamentary approval to go back to the creditors with a proposal very similar to the one he had walked away from a week earlier. Though the extreme left faction of his own party voted against the proposal or abstained, 251 out of 300 legislators voted to support him, including the main opposition parties. That set in motion the process of marathon negotiations in an atmosphere of deep mistrust, leading up to the agreement of 13 July.

However, the terms of the agreement are even tougher now than before. Continuing austerity and hardship for Greeks is guaranteed. But what is the guarantee that in a couple of years we will not see a replay of the same script again, with Greece seeking a fourth bailout?

There are two ways of approaching the solvency question. One is a simple accounting approach: raise taxes and cut expenditure in the budget to achieve a primary surplus, that is, reduce the debt:GDP ratio by reducing the debt. The other is a macroeconomic approach, which looks at the effect of tax and expenditure measures on both the numerator, debt, as well as the denominator, GDP, to assess the net impact on the debt:GDP ratio. It is an empirical question that depends on the value of the expenditure multipliers and tax elasticities that can vary from country to country.

The accounting approach, which the troika has applied in several other EU countries, seems to have worked. However, as **Olivier Blanchard**, chief economist at the IMF, has pointed out, in Greece, the multipliers turned out to be much stronger than anticipated, with a large negative impact on output reduction when expenditure was cut, and a knock-on effect on tax revenue reduction via tax buoyancy. Hence, sharp expenditure cuts reduced GDP and employment, but failed to eliminate the primary fiscal deficit. So will the austerity programme of the third bailout, with only a small component of under €50 billion to finance fresh investment over the next three years, ensure solvency or lead to a demand for a fourth bailout?

Much will depend on the impact of all the reform components in the adjustment programme on productivity, wage costs and competitiveness in the Greek economy. As **Michael Landesmann**, scientific director of the Vienna Institute of International Studies, explained to me in a recent conversation, low-cost labour from former East Germany and years of wage restraint played a key role in strengthening German competitiveness in the EU and global markets following its unification. The same has been achieved with several new East European members of the EU that have been integrated into the German supply chain. Greece, which is not part of that chain and exports only about 20% of its output, needs to focus on such new approaches to promote growth of output and employment, and thereby also establish solvency over the medium to long term.

Finally, this assessment will remain incomplete without recognizing a sad casualty of the Greek debt crisis, that is, the idea of a united Europe. Any federation of different geopolitical regions typically entails the unification of regions with uneven levels of development. The unevenness may persist after unification, but the aim of public policy is always to reduce and even out such differences. Look at our own federation of states in the Republic of India or any such federal country, northern and southern Italy, east and west Germany. After all, the sharing of fortunes, good or bad, and a common destiny is the very raison d'être of such unification. Such an inclusive vision of a future United States of Europe inspired the founding fathers of the European Coal and Steel Community that eventually evolved into the euro common currency area some 50 years later. Unfortunately, the united Europe project could never be completed without political, fiscal and banking union.

Meanwhile, the inclusive vision lies shattered today with the acrimony, distrust and internal divisions even among creditor countries that has arisen from the Greek debt crisis. On the one side there is Germany, along with several northern and eastern EU countries. On the other side there is Greece, supported by France and Italy, as well as Spain and Portugal, the other less developed southern EU countries. This divide between the countries of northern and eastern EU and those of the south and west is very damaging. Repairing this damage may indeed turn out to be far more challenging than restoring the sustainability of Greek debt.

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