Greek debt deal: Breakthrough or ball and chain?

Yiannis G. Sakkas and Yiannis G. Bazinas report on the historic debt-relief deal for Greece and the historic moment for the Eurozone as a whole

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On 22 June 2018, the Eurogroup reached what was termed a "historic" deal on a debt relief for Greece, a momentous achievement and the final step for Greece's return to economic normality, after almost a decade of European and IMF bailouts.

The debt package was portrayed in the public domain as "*an historic moment for the Eurozone*", "*the end of the Greek crisis*" and even "*the biggest act of solidarity that the world has ever seen*". However, the same enthusiasm is not shared by all. Concerns still persist that the agreed measures are not sufficient to restore debt sustainability. Even worse, the deal is conditional upon a continuation of strict austerity measures, which may prove the final nail in the coffin for the national economy. To avoid this, the future of the Greek debt relief inevitably requires a debt write-down.

The Greek debt deal

The current Greek debt package constitutes the latest episode in the long saga of the Greek sovereign debt crisis, which has been at the epicentre of the political debate in the EU for the better part of the last decade. With Greek public debt amounting to a nominal value of €340 bn. and corresponding to 180% of the country's GDP, it was widely accepted that a restructuring was essential in order for Greece to access the capital markets at the conclusion of the third bailout programme in August 2018. Such restructuring would seek to ensure that Greece is able to service its debt in the long run, without reliance on official sector financing. In technical terms, this translates to keeping the country's Gross Financing Needs (GFNs)[1] below 15% in the medium term and below 20% in the long term, as agreed by the Eurogroup on the 25th of May 2016.[2]

In order to achieve these targets, the country's European creditors agreed to restructure around €130 billion of loans extended to Greece by the European Financial Stability Facility (EFSF) in 2011. This restructuring will take the form of a deferral of interest and amortisation by 10 years and an extension of maturities for an additional decade. The deal also involves the waiver of certain extra interest payments on a portion of the EFSF loans (the so-called "step-up interest rate margin"). Furthermore, Greece will receive every semester, and until 2022, the profits made by the ECB and National Central Banks (NCBs) on their holdings of Greek bonds,[3] amounting to around €4 billion. Such payments, together with the disbursement of the final tranche of the current financial assistance programme by the ESM, amounting to €15 billion, will provide the country with a sufficient "cash buffer", so that it can access the markets with less difficulty. The Eurogroup also agreed to reconsider, at the end of the EFSF grace period in 2032, whether additional debt measures are needed in order to ensure that the agreed GFN targets are met.

The above arrangement however comes with a price. More specifically, in order to ensure debt sustainability, the Greek government has pledged to meet strict fiscal targets for the next decades, undertaking to achieve a primary surplus of 3.5% of GDP until 2022 and of 2.2% on the average, until 2060. In fact, the Eurogroup statement contains an annex outlining specific commitments by Greece "*to ensure the continuity and completion of reforms adopted under the ESM program*".[4] To make sure that these targets are met, Greece will be subjected to the Enhanced Surveillance Procedure, as its economic, fiscal and financial situation will be monitored on a quarterly basis. Such quarterly reports will also serve as the basis for the disbursement of €4 billion from the ECB's holdings of Greek bonds. Thus, while officially concluding the Third Financial Assistance Program with the ESM, the country will remain on a short lease for decades.

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Are the measures sufficient to restore debt sustainability?

While any debt relief would be welcome, the critical question is whether the current debt arrangement is sufficient to help Greece return to the markets at a sustainable rate.[5] In fact, the necessary extent of such restructuring has been a point of contention between Greece's two biggest creditors, the IMF and the Eurozone, for the past two years. The source of the disagreement is the divergent evaluation of Greece's ability to maintain the fiscal targets agreed, particularly regarding the evolution of the primary surplus. On the one hand, the European institutions appear confident about Greece's future fiscal performance and thus foresee that debt sustainability may be achieved through a combination of fiscal discipline and medium- and long-term debt relief, mainly involving the agreed reduction of the interest rates and the lengthening of loan maturities on EFSF loans.[6] On the other hand, the IMF has long been advocating that achieving and sustaining such high primary fiscal surpluses is highly improbable and that additional debt relief measures are required to ensure the sustainability of Greek public debt in the long run.[7]

The adequacy of the agreed debt relief measures depends largely on Greece's ability to achieve and maintain these fiscal targets. During the past years, Greece has pursued primary surpluses mainly through a strategy of over-taxation of the private sector[8], casting considerable doubt on their sustainability. For example, the country has managed to achieve, and even exceed, the target of a primary budget surplus of 1.75% for 2017 with tax hikes, increases in social security contributions and by not honouring internal payment obligations (holding back money owed to State providers, as well as by delaying the return of sale taxes and the payment of pensions). There is no need for a complex economic model to realise that through these tactics Greece will not be able to satisfy the attached conditionality for much higher surpluses over the next 42 years. In reality, the tax paying capacity has been exhausted following almost a decade of draconian austerity. Tax and social security contributions arrears are building by the millions each month and are now in excess of €130 bn., a 50% increase compared to 2014. Collection measures, imposed on State debtors, involving thousands of confiscations per day, have failed to bring as much revenue as expected. Also, the Greek welfare system is at a critical point and the unemployment rate is at 20.5%, placing Greece at the top of the unemployment table within the European Union. Some economists even argue that the fiscal targets are in reality much higher than portrayed in the debt agreement. It is suggested that when the applicable interest rates are taken into account, the required primary surpluses will be effectively in the range of 5.3% of the GDP through 2022 and of 4% of the GDP for the 2023-2060[9] period.

Inevitably, Greece will not be able to achieve the agreed primary surpluses, especially when taking into account that the government will have to drain

> **THE AGREED RELIEF MEASURES ARE, WITHOUT DOUBT, COMMENDABLE STEPS TOWARDS THE SUSTAINABILITY OF THE GREEK DEBT**

funds from the private sector at a substantial cost. It is noted that on the day of the Eurogroup meeting the Greek 10-year bond yield stood at 4,00 %, the lowest since February, but still the highest in the Eurozone. At the same time, there are no solid signs that this will dramatically improve. If nothing else, Greek bonds are most likely going to be among the less resilient to market swings. In fact, the IMF's projections suggest that, in the medium run, as official debt is substituted by more expensive borrowing from private sources, the country's financing needs will exceed 20% of the GDP. This will create a potentially explosive situation;[10] it is feared that in the late 2020s the Greek debt dynamics will again be unsustainable[11].

The impact of the deal on economic growth

While the Eurogroup's approach, requiring a high primary surplus for a very long time and allowing relatively little debt relief, is internally consistent, it is not consistent with international experience.[12] Evidence suggests that very few countries (mainly oil- and other resource-rich countries) have historically achieved such high fiscal targets for such a prolonged period of time, as agreed for Greece.[13] Furthermore, in these instances, high primary surpluses were backed by a strong real growth, rather than a strategy of fiscal consolidation. Greece will have to keep on track with its fiscal targets and foster economic growth at the same time. However, the one objective seems to negate the other, since the path to the required fiscal targets is paved with tough austerity measures. Unfortunately, such measures have only served to prolong recession, with the Greek economy sinking by 28% from its pre-crisis level. In reality, adherence to these fiscal targets will deprive the country of the necessary fiscal space in order to implement a growth-oriented policy.

The need for a debt write-down

The agreed relief measures are, without doubt, commendable steps towards the sustainability of the Greek debt, at least in the medium term. However, as explained above, the debt package does not go far enough to ensure that Greece will be able to stand on its feet in the long run. Greece, inescapably, needs a limited face value debt relief without any delay. If such decision is deferred for the future, the cost of a debt restructuring will be much higher than the additional debt relief required to make the debt sustainable today, considering that the official sector would in effect be repaying around €100 billion in expensive new borrowing acquired from the markets in the meantime[14].

Nevertheless, any discussion for a write-down is still an anathema for Greece's European creditors. Admittedly, there are sound arguments to support this stance, centering on moral hazard, EU Treaty constrains, etc. However, the key obstacle in finding a solution to the Greek debt crisis is, and has always been, political, and not economic or legal. The real economic substance of the Greek debt resolution was settled long ago, when official creditors agreed to take on the majority of the country's debt and shoulder the risk of a future Greek haircut.[15] Thus, if a political decision is made to solve the Greek debt problem, there are plausible ways to do so without aggravating moral hazard and, at the same time, being in line with Article 125 of the Lisbon Treaty, which provides that Member States may not bail-out fellow EU countries. Namely, the face value debt relief will need to be structured in a way that strengthens budgetary discipline, linking measures to fiscal turnouts and clawing back relief when imposed targets are not respected[16]. A restructuring along these lines will not only provide a substantial opportunity to the national economy to grow but, more importantly, fit much better the description of a "*historic moment for the Eurozone*". ■

Footnotes:

1 Gross financing needs (GFNs) are defined as the overall new borrowing requirement plus debt maturing during the year. Essentially, they measure how much a country must borrow each year in order to service its debt, given its income and noninterest expenditures. See IMF Fiscal Monitor 2015, Glossary.
2 Available online at https://www.esm.europa.eu/press-releases/eurogroup-statement-greece-25-may-2016.
3 These profits refer to interest income on bonds held by the ECB as a result of the Securities Market Program (SMP), which was instituted in 2010 and discontinued in 2012 and by the Eurosystem Central Banks also hold sovereign bonds (among them also Greek ones) in the context of the Agreement on Net Financial Assets (ANFA). The Greek sovereign bonds held by those institutions were acquired before 2012 and thus were not subject to the 2012 Greek bond restructuring.
4 See Annex to Eurogroup statement on Greece of 22 June 2018 available online at http://www.consilium.europa.eu/en/press/press-releases/2018/06/22/eurogroup-statement-on-greece-22-june-2018/
5 Brookings. 2018. Is the latest Greek debt deal sustainable or another kick of the can? Available at: https://www.brookings.edu/blog/up-front/2018/06/27/is-the-latest-greek-debt-deal-sustainable-or-another-kick-of-the-can/. [Accessed 7 August 2018].
6 Zettelmeyer, Jeromin, Kreplin, Eike, and Panizza, Ugo, Does Greece Need More Official Debt Relief? If So, How Much? (April, 2017). Peterson Institute for International Economics Working Paper No. 17-6.
7 IMF, Greece: Preliminary Debt Sustainability Analysis, May 2016.
8 Sakkas, Y and Bazinas, Y, Boom or Doom, International Financial Law Review, July/August 2017.
9 See https://truthout.org/articles/eus-debt-deal-is-kiss-of-death-for-greece/.
10 IMF, Greece: Request for Stand-By Arrangement—Press Release; Staff Report; and Statement by The Executive Director for Greece, July 2017.
11 Zettelmeyer, Jeromin et. al., How to solve the Greek debt problem (April 2018). Peterson Institute for International Economics Working Paper No. 18-10.), PIIE.
12 *ibid*
13 Eichengreen, Barry and Panizza, Ugo, A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve its Debt Problem? (July 2014), National Bureau of Economic Research Working Paper No. 20316.
14 See Zettelmeyer (2018).
15 Bulow, Jeremy, and John Geanakoplos, Greece's Sovereign Debt and Economic Realism. (June 2017), CEPR Policy Insight 90
16 See Zettelmeyer (2018).