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GREECE: A BUMPY ROAD TO SALVATION

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NEGOTIATIONS FOR THE COMPLETION of the first review of the third bailout programme for Greece are approaching a critical stage, with the Greek government resisting some pension and tax changes, while creditors insist on credible and rigorous implementation. Differences are bridgeable within a couple of months, and a positive outcome would open the door for debt relief. However, there are risks related to the evolving political situation, the lack of ownership by the Syriza government, the still-large fiscal gap to be delivered, potential additional social unrest, the expected impact of fiscal measures on the economy and the outlook for potential growth over the medium term.

The first review of the third Greek bailout programme for €86bn started at the beginning of February in Athens. Negotiations between the Greek government and Greece's international creditors (represented by the so-called "Quadriga", the IMF, the Commission, the ECB and the ESM) should lay the groundwork for an agreement at staff level, which should then open the way for debt relief negotiations.

It is with a déjà-déjà-vu feeling and lots of mistrust that negotiations started with the usual noises, with the Greek government trying to put forward its red lines and creditors making tough statements (probably the toughest is the renewed threat of Grexit by German Finance Minister Schäuble). The impression is that without the usual drama we are not going anywhere, but time plays in favour of an agreement.

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Indeed, there is one point on which all agree: “time is of the essence”. It makes sense for all parties involved, although for different reasons, to close the deal as soon as possible. The Greek government correctly perceives that it is the current uncertainty that is killing any possible recovery and feels all the urgency of closing the deal and getting debt relief. Creditors are very busy with a number of other issues now, possibly even more important and politically charged, such as the immigration crisis, so further Greek turmoil would be an unwanted distraction.

There is also plenty of fatigue. The Greek government represents the suffering of Greek people after many years of deep recession and just wants to move on. Creditors are simply fed up repeatedly discussing issues related to Greece. Whether this fatigue translates into a take-it-or-leave-it rigid stance or a more accommodative attitude is still not clear.

(Catholic) Easter Sunday falls on 27 March this year. Taking into account that the week before Easter is a holiday period in many countries and at the Commission, the unofficial deadline for reaching a staff level agreement would be the week of 14 March. Then the sequencing would be tricky and it would be all about slicing decisions into politically palatable chunks.

The ECB can autonomously decide on re-introducing a waiver for Greek bonds to allow them to be used again as collateral for financing operations at the ECB. This can happen any time soon after the staff level agreement. However, allowing the ECB to include Greek government bonds into the Asset Purchase Programme (APP) can only happen at the end of the process once debt relief is decided.

Negotiations on debt relief will start soon after the staff level agreement, although at a technical level the IMF and the Commission are already working on a number of possible options and on the Debt Sustainability Analysis (DSA), which is the basis for any agreement. Negotiations on debt relief will be mainly a matter between the European creditors and the IMF, who is keen to have a sustainable position as a precondition for its participation in the financing. It is expected that these negotiations could last about a month.

Only once these negotiations are concluded, can the whole issue go to the board of the IMF for a decision and then to an Ecofin Council for the final blessing of Europeans. Therefore, this could be done by late April. There are no binding financing needs for Greece before June/July, but taking into account the necessary time to finalise technical details and negotiations on debt relief, the time limit for a staff level agreement is May and for finalisation of the review and debt relief is June at the very latest.

The idea of a pre-commitment and frontloading on debt relief is now accepted (explicitly or implicitly) by all European countries and all the institutions involved in the negotiations. Some conditionality, i.e. making part of the relief subject to acceptable implementation of the legislated reforms, is also likely but it may come, for instance, from the payments by the ECB of the gains from the Security Market Programme. Please note that the IMF stake is super-senior to everything. The debt in the hand of the private sector is rather small by now and private sector investors suffered a sizeable haircut in the past.

Therefore, it would not be appropriate to penalise investors while the government is looking to attract foreign capital and fix the problems of banks, which are the largest private investors in government bonds. As a result, private sector involvement appears very unlikely. It is also widely accepted (at least between Europeans and the IMF) that there will be no haircut and thus that the debt relief will come in the form of extension of maturities, grace periods and interest rate reductions. It is also likely that the metric for the decision will be a gross financial need below 15 per cent of GDP (although this metric is very sensitive to the underlying assumptions).

Many countries strongly want the participation of the IMF in the programme and in some countries parliamentary resolutions explicitly call for IMF involvement as a precondition for approval (including the Netherlands, Finland and Germany). It would also be in the interest of the IMF to continue to be involved given its large exposure to Greece. The IMF may become a strong enemy to the Greek government on matters related to pensions but it may turn into a stronger ally in talks over debt relief.

Can the refugee crisis interact with the negotiations on Greece? Now the two processes are completely separate. However, the refugee crisis may become part of a grand political bargaining at the end of the negotiations. Finally, some attributed the support of the US Administration for the renewal of Christine Lagarde's five-year mandate as IMF managing director to the desire to force a deal on the Greek situation as soon as possible.

Politics, Politics, Politikí

Politics is probably the key variable in assessing the chances of a positive conclusion of the negotiations and the medium term success of the programme. Alexis Tsipras is losing consensus among his electorate and, according to some opinion polls, New Democracy (ND) is now in the lead, following the appointment of Kyriakos Mitsotakis as its leader on 10 January.

New Democracy's revival is changing Greece's political landscape. There have been defections from Syriza and now the government is left with a razor-thin majority of just 3 members of Parliament (153). Some political commentators claim that Tsipras may lose up to 15 members of his party soon. If the government no longer has a majority in parliament, new elections would be called and Syriza may lose these to New Democracy. This is why a positive conclusion of the negotiations with creditors would give Tsipras a much-needed boost. In all this, Mitsotakis seems to be playing a waiting game, being in no hurry to trigger a political crisis or elections.

Parliament approved the Memorandum of Understanding (MoU) with about 75 per cent of votes back in August. It will be difficult for political forces not in the government coalition to support the approval of the deal this time, but there is nevertheless a way they can provide external support. If the current government coalition fails to secure the necessary majority in parliament, passing the remaining measures and finally approving the deal with creditors, members of small opposition parties (Pasok and To Potami) could abstain or not show up, thus allowing the programme to go ahead. Even New Democracy could decide to avoid the vote, thereby allowing the government to have a majority.

A more fundamental issue is the attitude of the government towards the MoU. Tsipras makes no secret that he does not like the MoU, although he is committed to its implementation, raising a significant issue concerning ownership. The ideological view of the government appears fundamentally different from the philosophy of the programme. There are members of the government with anti-business sentiments and some are openly obstructing the implementation of the programme. For instance, Christos Spirtzis, the Minister of Infrastructure, Transport and Networks, announced that the government would stop the privatisation of fourteen regional airports: "The central position of the government is to stop the privatisations of infrastructure which serve and can help the development of the country."

If there were no compromise with the country's creditors, the Greek economy would suffer again from bouts of severe uncertainty and fresh market turmoil. This may eventually lead to a change in government and a more favourable stance towards the MoU, although this is not granted given the experience of the Samaras government.

As a result, the big gamble for Tsipras is to close a deal with creditors as soon as possible to obtain debt relief, the waiver by the ECB and then the inclusion of Greek bonds into APP. This could provide a boost to the Greek economy and his political future. Given the current configuration of interests, the risk of another political crisis in the near term seems rather small, but it may become high once the programme and debt relief are out of the way. At least on paper, it looks like a win-win proposition: if Tsipras delivers on the MoU it would be a plus for Greece and Greek financial assets, if he does not deliver this may lead to a new government with a different attitude towards the MoU.

Poisoning the well?

According to the Greek Constitution, with a two-thirds majority in parliament the government can change the electoral law effective from the next elections. With only a 51 per cent majority it can change the electoral law effective from the elections that follow the next ones. Tsipras proposed to change the electoral law to make it closer to a proportional system with no majority premium. This would please smaller parties like Pasok and To Potami, and could become a way to convince them to support the government, although this would come at the price of undermining the prospects for government stability and likely condemning Greece to coalition governments.

There is a major historical example. In 1989, Papandreou's Pasok government modified the electoral system a few months before general elections, requiring a party to win 50 per cent of the vote in order to govern alone. Kostantinos Mitsotakis, then leader of New Democracy and father of the current leader Kyriakos Mitsotakis, was unable to form a government even though New Democracy was the clear first-place party, with 20 more seats than Pasok. This led to a long period of deadlock, and forced New Democracy to enter a coalition agreement despite winning one of the most decisive victories in modern Greek history (27 seats ahead of Pasok). Mitsotakis' government turned out to be extremely weak, with a majority of only one vote.

Such a move would be highly controversial and is perceived to be a nuclear option. It would likely lead to the worst possible outcome for the future of Greece and the MoU. Some political commentators perceive such a move as highly likely; others as unlikely. It would be a way for Tsipras to poison the well and reduce the incentive to go for elections over the near term at the price of more political instability in the future.

Can Greece grow out of its problems?

Following the collapse of the economy in 2009-13 and two bailout programmes, Greece was the Eurozone's fastest-growing economy in the third quarter of 2014. It was heading for a strong recovery which would have questioned the view of permanent supply-side damage to the economy. Unfortunately, there was no agreement on new support measures with creditors and, following unsuccessful elections of the President of the Republic, new general elections were called leading to the victory of Syriza in January 2015.

The uncertainty that followed led to a fresh downturn in confidence and in economic growth in the first half of 2015. In the summer of 2015, when the MoU was signed, expectations were for another big drop in economic activity in the second half of the year and in 2016. Yet the economy proved surprisingly resilient and confidence recovered sharply after the MoU agreement. GDP growth fared far better than expected in the second half of 2015, with a much shallower recession than envisaged.

Capital controls introduced in mid-2015 were widely anticipated by Greek consumers and businesses and this partly explains the resilience in the economy: (1) households hoarded cash to the tune of 30-40 billion euros, (2) they started buying durables as a store of value for money, (3) companies increased inventories in the first half of 2015 in anticipation of capital controls, and (4) they were able to bypass capital controls by opening accounts abroad to be used in import/export transactions. Finally, extended families acted as automatic stabilisers. SMEs were probably the economic agents that suffered the most from capital controls.

Since then, capital controls have been eased. Requests of small money transfers are approved directly by commercial banks, with the rest by the Bank of Greece, which claims that there is no backlog of authorisations. Moreover, the rejection rate is less than 5 per cent and it mainly relates to portfolio flows. Trade flows are authorised swiftly.

Now the economy appears to be stabilising. The Bank of Greece expects GDP growth at 0.0/-0.5 per cent in 2015 and -0.5/-1.0 per cent in 2016 due to a large negative carryover from 2015. The European Commission forecasts published on 4 February showed a flat reading for 2015 (0.0 per cent) and -0.7 per cent in 2016, broadly in line with the Bank of Greece's expectations. However, the frontloading of the bailout programme may result in a larger-than-expected negative impact in 2016.

There is uncertainty on the medium-to-long run prospects. According to the Bank of Greece, potential growth is likely to be slightly above 2 per cent (before the crisis it was about 3 per cent due to easy credit conditions). Following a massive contraction in GDP (24 per cent) and in industrial production since the outset of the crisis, it is not clear how much productive capacity is left and whether there has been permanent damage to the potential of the economy.

Credit to the economy may remain constrained for a long while, mainly due to a large stock of non-performing loans in the books at banks. Finally, before the crisis investment activity was close to 25 per cent of GDP and it has now reduced to about 10 per cent of GDP. This inevitably will have implications for potential growth, although it may also be an opportunity if there is a sharp rebound in investment activity from now on. The bottom line is that the medium-term path for growth remains highly uncertain.

Banks are not out of the woods yet

Back in August 2015, the MoU pencilled €25bn for bank recapitalisation. Following successful capital increases by banks, far less bailout funds were eventually needed. Core tier 1 capital of the four major banks is now at about 18-20 per cent, extremely high by European standards. However, the stock of non-performing loans is equally very high. Provisioning is relatively high as well. Still the size of the stock is so large that concerns remain. Moreover, there is clearly political opposition to foreclosures as the government tries to protect borrowers. Finally, banks still have major governance issues that need to be addressed.

This is why the 'Quadriga' is focusing on financial sector reforms. At the end of last year a financial sector framework reform was introduced, but the work was done in a hurry. There is now a need to reconsider it, fixing mistakes and introducing pieces of legislation that are still missing. Moreover, part of the reform has not yet been implemented, waiting for pieces of secondary legislation. In particular, there is a need for (1) spelling out the insolvency law, (2) completing the legal framework to address the issue of non-performing loans, (3) allowing for professional management of non-performing loan positions, (4) improving coordination among lenders for restructuring, (5) force restructuring of non-performing loans whenever needed, (6) introducing asset management companies, (7) setting up specialised courts.

The government has opposed a number of ideas put forward by creditors and the Hellenic Financial Stability Fund and tends to protect borrowers. In the case of Greece, the non-performing loan issue is more difficult than in other countries as the problem is not 'asset class specific' but broad based. There are also 'strategic defaulters' who inflate the overall stock of non-performing loans. There is thus a need to make sure that those who pay are not penalised. A good step in the direction of introducing effective incentives was to guarantee at least 65 per cent of the proceeds to banks that go for foreclosure (making them senior to tax authorities etc.)

Are differences in the negotiations bridgeable?

Here are the key issues still open: (1) the pension reform, (2) the tax reform, (3) the overall fiscal adjustment (4) some aspects of the privatisation process and (5) financial sector reforms. The creditors, and especially the IMF, want to have credible fiscal targets backed by solid measures that add up, and clearly, the passing of primary legislation would not be enough in many instances. Thus, there will be close monitoring of implementation over the coming quarters.

It is widely accepted that more than 80 per cent of the MoU has already been legislated by the Greek government (see the EU Commission's compliance reports in November and December), although there are still important pieces missing. There is still a gap of about 1.0-1.5pp of GDP of fiscal measures in order to reach the 3.5 per cent primary surplus required by the MoU over the medium term.

The IMF appears to be flexible on the fiscal adjustment, provided Europeans take the slack in terms of extra debt relief (admittedly not an easy option to stomach). The 'Quadrige' will not have to tick all the boxes of the MoU in order to give the green light of the staff agreement. 'Broadly compliant' is usually the language used, meaning that not all aspects of the MoU need to be delivered for the agreement to take place. Thus, the focus of the review will be on big-ticket items.

A 3.5 per cent primary surplus can be achieved

Creditors are keen to agree on a credible programme that adds up, with focus on the quality of measures and expected impact on the economy. Achieving the fiscal targets set by the MoU remains ambitious. The primary balance target for 2015 was -0.25 per cent of GDP, for 2016 0.5 per cent, for 2017 1.75 per cent and for 2018 and beyond 3.5 per cent. The gap versus current projections is estimated at about 1.0-1.5 per cent of GDP and there is a need for at least 1.0 per cent of GDP to be delivered immediately by a supplementary budget.

Greece achieved a primary government budget surplus of 0.4 per cent of GDP in 2014, although in 2015 it deteriorated to -3.5 per cent. There is a lot of discretion in setting up adjustment programmes in case of financial assistance and it is widely agreed that targets should be expressed in terms of primary balances. Still, if we believe that the output gap is very large, simply allowing the economy to recover would sharply improve public finances and make the achievement of a 3.5 per cent primary surplus well within reach.

The two big-ticket items to achieve fiscal targets are a pension reform and a tax reform. There is also an issue with the financing of arrears. Due to financial distress, since March 2015 the government has increased them by €2bn, although an exact count is still under way.

Most of the savings are expected to come from another pension reform, although there seems to be slightly different view between the IMF and the EU Commission, with the former looking at a pension reform to achieve near-term savings while the latter is more focused on long-

term sustainability. It is accepted that the framework introduced by past reforms is still valid and thus most of the changes that are required will be ‘parametric’, i.e. with a far smaller implementation risk than many other reforms. There is also the tricky issue of addressing the 2012 Constitutional Court ruling, which has effectively reversed some aspects of the reform (with a shortfall of 2 per cent of GDP).

The government has proposed to increase contributions, possibly only on a temporary basis, although this goes in the opposite direction of reducing labour costs and thus making the economy more competitive. It is also looking at decreasing pension payments only for new pensions. Creditors are effectively proposing a freeze of all pensions in nominal terms as replacement rates are still rather generous and the overall pension outlays very high as a percentage of GDP (about 18 per cent). In parallel, spending on welfare is low by European standards and thus a rebalance would be very much welcome. Harmonising different pension treatments that have developed over the years would also have to be fully addressed.

Tax changes are also critical as they would affect farmers more than other categories of citizens, and they usually can generate major protests and produce disruptions. Farmers currently pay little tax and have large fiscal benefits and these need to be addressed as a matter of fairness by the government. Moreover, VAT for the islands has to be put in line with the rest of the country. No government proposal has yet arrived on these matters. The MoU also requires the setting up of a new independent revenue agency.

Reforms: greasing the wheels of the economy

According to the OECD monitoring of structural reforms, Greece is the country that has delivered the most in terms of structural reforms over the past few years. True, OECD statistics are based on legislated reforms rather than actual implementation, and the starting level may have been much worse than in most other countries. Nevertheless, it is fair to acknowledge that Greece has already done a lot. Estimates by the Bank of Greece, broadly in line with those of the Commission and the OECD, suggest that past reforms will increase the level of GDP by 6-10 per cent over the medium term.

In the first programme (2011) labour market reforms and firm-specific contracts were introduced and that led to a sharp decline in wages. In the second programme (2012), product market reforms were also introduced abundantly, although many remained on paper. For instance, the reform of the electricity market may prove even more controversial than pensions. Labour reforms appear to have produced the desired results and be sufficiently effective, but on product markets there is still plenty that needs to be done.

There are two areas of concern. First, the commitment of the government to modernise the public administration, as it touches the political constituency of Syriza and vested interests. Second, there is the general attitude towards businesses and investment. This includes (1) progress on privatisation (for instance the privatisation of 14 regional airports and that of the Piraeus and Thessaloniki ports), (2) effectively applying the rule of law, (3) the government’s interventionist stance on the economy, and (4) the stability of the tax environment.

Give Greece a chance

In Ancient Greece the Delphi Oracle was famous for its predictions. One such famous prediction was the answer to an unknown person who was inquiring as to whether it would be safe for him to join a military campaign. The answer was: “Go, return not die in war”, which can have two entirely opposite meanings, depending on where a missing comma is supposed

to be – before or after the word “not”. Nevertheless, the Oracle seems to have consistently advocated peaceful, not violent courses of action.

Equally, the missing commas of the MoU can make the difference, but all actors involved in the negotiations would be better advised to follow a peaceful and constructive course of action leading to a reasonable compromise, completion of the review and the opening up of debt relief as soon as possible. It would not be constructive to threaten again a Grexit, as well as it would not be useful on the part of the Greek government to resist reforms the large majority of which are simply common sense economics. Ultimately Greece deserves to have another chance.