The modern Greek tragedy

Jeremy Bulow, Kenneth Rogoff, 10 June 2015

The conventional wisdom in Greece is that the nation has suffered years of excessive, Troika-imposed austerity in a short-sighted effort to extract maximum repayment. This column argues that, in fact, Greece was a net receiver of Troika funds from 2010 to mid-2014, with a modest reverse flow since Greece stalled on its reforms. Both sides have negotiated in their self interest – influenced by bargaining threat points that have had everything to do with the direct costs of default and little to do with Greece's concern about its reputation for making repayments.

A European nation with a proud heritage, Greece is nevertheless still an emerging market in many respects, and its economy has suffered the kind of epic depression that entrenched high-income countries have managed to avoid, even in the Great Contraction. Greece's per capita GDP (in dollars), which had risen from 41% of German levels in 1995 to 71% in 2009, was back to 47% by 2014. On a purchasing power basis the decline was nearly as significant, from 77% of German levels in 2008 to 57% in 2013.

The conventional wisdom, certainly in Greece, is that the country has suffered through five years of excessive austerity, imposed by the IMF and the EU (primarily led by Germany), in a misguided effort to repay the country's private creditors and to suck cash out of Greece. This view, although often reinforced by some academic commentators, is wrong. The aim of this note is to lay out the facts as best as we can ascertain them. In doing so, we hope to help illuminate some of the underlying strategic bargaining issues in a way we hope will be of interest to both academics and to observers of Eurozone debt negotiations. (We look more directly at the theory of sovereign debt contracts, and how the Greece case might be illuminating, in a separate companion piece more narrowly directed at researchers.)

Early motivations for lending to Greece

It is true that a major early motivation for the EU to lend to Greece was to subsidise its banks, but it is not true that Greece's creditors were taking money out of the country, at least until the Greeks chose to postpone or stop meeting the terms of its second bailout deal in the second half of 2014. Europe continued to provide cash inflows to Greece until that time, on top of the banking system support it still provides, and arguably does not really expect to be a net receiver of very much if any money over the next few years (at the very least). The bailout deals negotiated with Greece were meant to provide it with the cash needed to ease the transition from running primary deficits in its heavy borrowing years and to help keep its banks running and its private creditors at bay. The problems that Greece faces are due to a loss of confidence in the state, not only by foreign private investors but also by Greece's own citizens. Indeed, the latter have withdrawn over a hundred billion euros from the banking system since the onset of the crisis in early 2010. While Europe has replaced much of this money through Target2 loans (now primarily 'Emergency Liquidity Assistance') the Greek banks have also been weakened by the 33.5% of their private loans that are non-performing, reducing their capacity to take on new risky loans. It is partly for this reason, as well as because of the losses Greek banks suffered in 2012 on their holdings of Greek Government Bonds, that a significant part of the new money that Greece received over the past five years had to be used to recapitalise Greek banks.

Whereas the EU has actually been a net provider of funds to Greece since the beginning of the crisis, this is not to say that its motivation has been entirely charitable. Greece has been able to combine the threat of default (which would create an unknown and potentially massive risk for the EU), a promised commitment to economic reforms that would put it on the road to self-sufficiency, and its 'too small to fail' status to gain extraordinary financial support. Over time, the risks of 'Grexit' – Greece leaving the euro – while still unknown, appear to have lessened for most observers. At the same time, the Greeks have recently elected a party seemingly intent on rolling back some of the country's hard-won economic reforms, negotiations have become harder. Nevertheless it seems unlikely that in any deal Greece would be asked to pay back as much cash as it receives in net subsidies from the EU, at least for a

long time to come.[1]

Tragedy

The tragedy for Greece is that it borrowed heavily in the good times of the early 2000s, even though it already had a high debt to GDP ratio and could have used its fast growth rate as an opportunity to reduce the burden of its debt, not to increase it. Instead, like many countries, its governments borrowed what they could, and the combination of the Great Contraction and the revelation of massive accounting fraud shut the door on private lending. Relative to other countries that have found themselves in debt crises, Greece was able to lever its position in Europe into a two extraordinarily massive (by any measure) bailout programmes meant to provide the country with funds while it reformed its economy and its government budget. But as a member of the EU, Greece could not devalue its currency and reform has been enormously difficult politically. And while in some ways Greece has gotten a good deal, its bargaining partners have of course been focused on their own welfare and political problems. The mistrust of the Greek government, by its European bargaining partners but also crucially by its own citizens, has made a turnaround slower and even more painful than in other Eurozone countries.

What happened to Greece between 2006-2015?

We begin by comparing the net cash flows that Greece received during the last four years when it could borrow with market access, 2006-09, to the first four years that it depended on EU funding, 2010-13, and then show what has happened in 2014 to early 2015 as Greece and its creditors have been at an impasse. Tables 1 and 2 shows the relevant information for Greece's economy in billions of euros for 2006-09 and 2010-13 respectively (taken from EU and National Statistical Service of Greece data).

Table 1. Greece's economy, 2006-09.

Table 2. Greece's economy, 20010-13: Total inflows increase as the economy declines

Change in outstanding debt:	86
Less: Consolidated interest	(44)
Plus: Adjustments	10
Plus: EU subsidies	20
Total Inflows	72

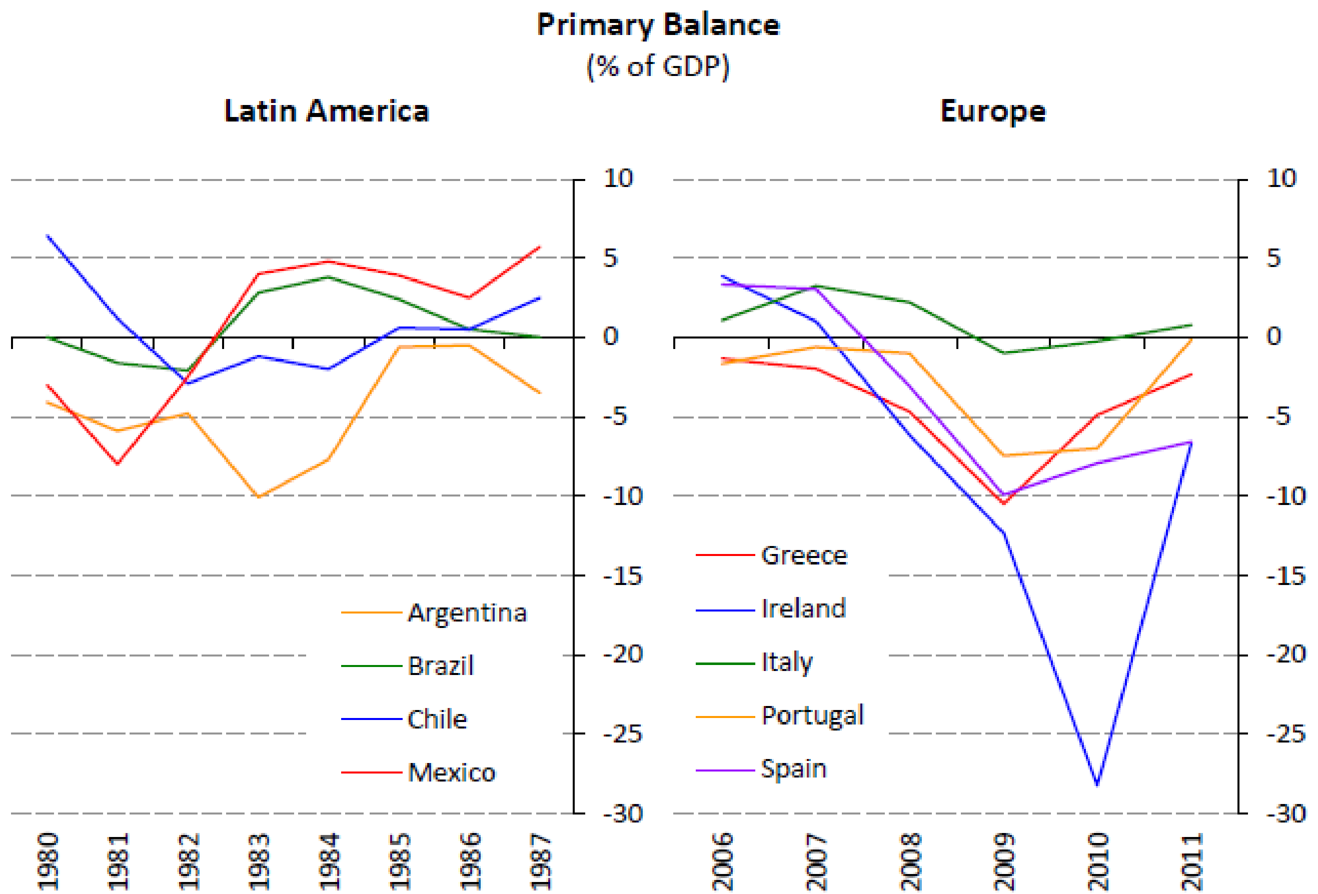
Change in outstanding debt:	18
Less: Consolidated interest	(45)
Plus: Adjustments	106 (the debt write-down due to the PSI program)
Less: Increase in accounts payable	(6)
Plus: EU subsidies	18
Total Inflows	91

The 2010-13 total is inflated by a €10.9 billion payment for bank recapitalisation that went unused and was subsequently reclaimed by the European Stability Mechanism lenders in 2015. But even without this, inflows averaged €20 billion a year in 2010-13 vs. 18 billion in 2006-9. That is, the EU, ECB, and IMF combined to cover all payments made to private creditors and added in new money that slightly exceeded what Greece had borrowed in the previous four years. However, if we subtract out the full cost of the bank recapitalisation programme – necessary because of the banks' losses on Greek government debt – the amount left to run primary deficits, pay other

outstanding bills, and build a cash buffer falls to €43 billion. In addition, the Greeks will benefit from having most of their debt transferred from private creditors to official creditors who are much less focused on repayment.

The contrast with countries that did not have Greece's bargaining advantages is stark. The major Latin American borrowers in the 1980s, with the exception of Argentina, were forced to move from primary deficit to primary surplus almost overnight when their private lenders started to run, because official creditor bailouts were much less forthcoming – even though Greece started with a much higher ratio of debt to GDP than the Latin borrowers (see Figure 1).

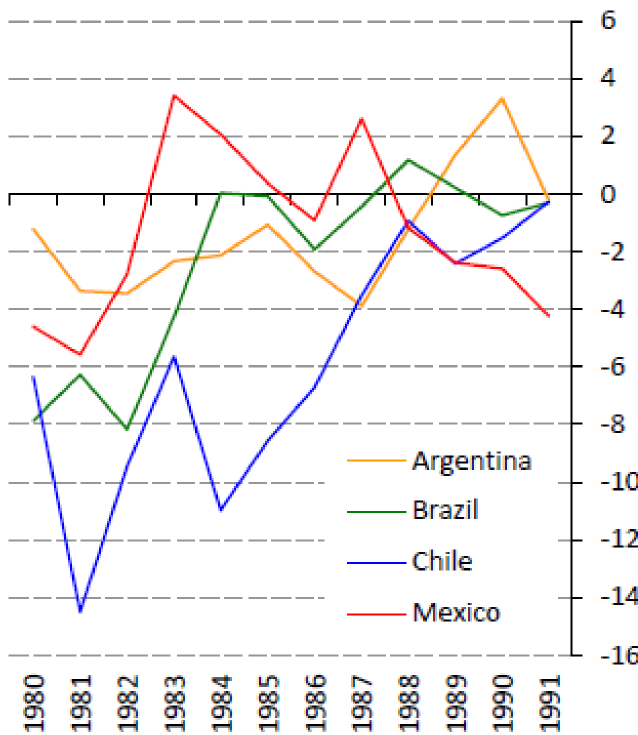
Figure 1. Primary balances and current accounts of Latin America and Europe, 1980-2011



Current Account

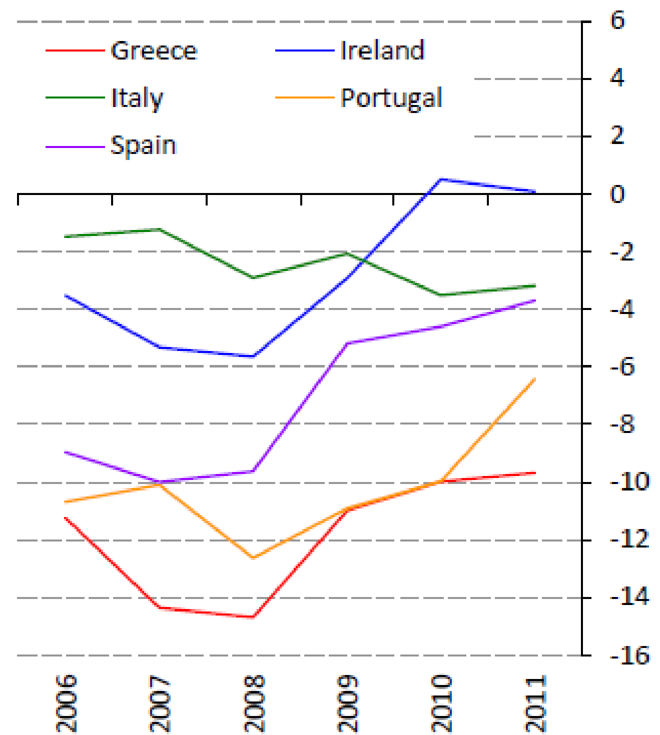
(% of GDP)

Latin America



Source: International Monetary Fund.

Europe



Source: International Monetary Fund.

Source: Ramos-Francia et al. (2014). Note that cash subsidies from Europe count towards surpluses.

Cash flows turned negative in 2014 as Greece had to make payments on some long term debts, including some bonds issued under UK law that failed to participate in the €107 billion euro ‘Private Sector Involvement’ write-down, and the Samaras administration felt political pressure to back away from Troika programme requirements even at the cost of postponing the receipt of bailout funds. This has led to a period when the Greek government has drawn down its cash reserves as the temporary alternative to defaulting on the one hand and complying with its second bailout agreement on the other.

Table 3 shows the cash flow data for 2014, available in somewhat greater detail than for earlier years.

Table 3. Greece’s cash flow data for 2014

Type of Debt	Issues Minus Redemption	Interest	Fees	Net Cash
T-bills	-.442	0.373	0	**-0.815**
Long Term	-9.736	2.839	0.004	**-12.579**
Short Term (Repo)	8.605	0.010	0	8.595
Bank of Greece + Other Residential				-0.556
EFSF/ESM/IMF				**2.927**
Other Non-Residential				-0.534
Settlement of Past Years' Obligations				-1.152
Participation in Share Capital Increases				**-0.493**
ANFA + SMP				**0.580**
From EU				**4.845**
Net Foreign Flows (sum of bold items)				**-5.535**

Source: General Government Monthly Bulletin, December 2014.

Summing, net cash flows for 2014 from the bolded foreign sources (so excluding, e.g. repo) were -5.5 billion. Note that ANFA and SMP are programs to rebate to Greece the "profits" that official creditors make on any Greek bonds they have purchased and on any loans that they make, contingent on Greece sticking to the terms of its bailout deals.

As is well known, repayments continued in the first quarter of 2015, this time because some official debts came due and there was yet to be an agreement to complete the current bailout plan and start the next one:

Type of Debt	Issues Minus Redemption	Interest	Fees	Net Cash
T-bills	0422	0.094	0	**0.328**
Long Term	-0.025	1.149	0	**-1.174**
Short Term (Repo)	1.195	0.054	0	1.141
Bank of Greece + Other Residential	0.002	0.012	0	-0.010
EFSF/ESM/IMF	-13.477	0.777	0.058	**-14.312**
Other Non-Residential	-0.087	0.090	0	-0.177
Settlement of Past Years' Obligations				-0.120
Participation in Share Capital Increases				**-0.462**
ANFA + SMP				**0**
From EU				**2.271**
Net Foreign Flows (sum of bold items)				**-13.349**

Source: Government of Greece 2015.

So for this period Greece paid out about €13.35 billion euros net, of which €10.9 billion were returns of the bank stability funds which the government was never really able to get its hands on, implying net repayments of around €2.5 billion. (The creditors may ultimately 'repurpose' the remaining bank funds to allow Greece to use them to make debt repayments, as part of a bailout extension).

Given that Greece claimed to be running a small primary surplus in 2013-14 what kept it from defaulting on its debts and trying to wipe the slate clean? Clearly, it is implausible that the reason has anything to do with maintaining any reputation for repayment it might have built since the twelve figure debt default (Private Sector Involvement write-down) of 2012 (see our paper for a full discussion of the academic debate on whether countries mainly make debt repayments to maintain a reputation as a reliable borrower).

Greece wants a deal

But there are tangible reasons for Greece to want a deal:

- First, a default would likely have cost it the €5 billion a year it receives in annual EU subsidies;
- Second, it would have put at risk other benefits Greek citizens derive from being in the EU, including the ability to work in other countries, move capital across borders, and trade freely;
- Third, even when the Europeans were not providing cash transfers directly to the Greek Government they were providing financing to the Greek private sector, basically to offset the capital flight from the banks, on terms that were vastly more generous than what the banks could have hoped to obtain from private lenders – who in fact probably would not have been willing to lend nearly as much on the same collateral regardless of the interest rate.

Private sector deposits fell from €238 billion euros at the end of 2009 to €134 billion at the end of April 2015 (Bank of Greece 2015). At the same time Greece built a Target2 balance (see Euro Crisis Monitor 2015) largely composed of over €80 billion in emergency liquidity assistance funds, that approached €99 billion at the end of April 2015. Even though it is not clear that the average Syriza voter understands that the creditor countries have been net givers of money rather than takers for most of the crisis, and that a default risks other problems as well, surely this is well understood by decision makers (although, however, this fundamental point seems to escape a large percentage of press, and even academic pundits, who write about Greece).

Greece seen as a developing country

At the same time, Europe has become frustrated with Greek progress in instituting economic reforms. Greece has significantly improved its World Bank rating in terms of ease of doing business (Doing Business 2015) but its 61st place in the rankings is still just behind Tunisia, and far behind Iceland (12), Ireland (13), Portugal (25), and Spain (33). On individual measures its performance is also poor. In enforcing contracts it ranks 155, one behind Malawi. On paying taxes it is one behind the Solomon Islands. On starting a business, Tonga; on construction permits, Peru; on registering property, Morocco. The fact is that Greece in many ways is still a developing country, and it has actually made some significant improvements to get to where it is now, or at least was a few months ago. But it has not been able to take the steps necessary to have a business environment as friendly as other European countries. Politically, top European leaders surely understood that the expected costs of the Greek bailout programmes were very large, and the possibility of eventual large transfers from Greece to repay the likes of France and Germany still seems remote. In most of Europe, there is bailout fatigue, and it is hard for European legislators in many countries to agree to give more to Greece. So the costs of giving Greece more money and accepting more emergency liquidity assistance exposure are complemented with increasing political costs of making a deal.

Finally, the fact that the Greek government does not appear capable of long-term commitments (with multiple bailout

renegotiations, a volatile electorate, and a fractious and inexperienced governing party), is also a significant constraint on any bargaining arrangement. In economist jargon, deals have to be renegotiation-proof. You can make a deal that is supposed to last for several years, but you have to be aware that one side may demand renegotiation at any time. This explains the 'extend and pretend' nature of the negotiations, as Bulow and Rogoff (1989) emphasised over 25 years ago, where bargaining involves 'constant recontracting' and is primarily about the cash flows and commitments for the coming year or even month, and, as with the Baker plan days in the first few years of the 1980s Latin American debt crisis, negotiations over a write-down in the face value of debt only happen when one of the creditors is to be bought out. By contrast, it is hard to interpret anything that Greece (or, say, Argentina) does as being influenced by a desire to build a reputation as a cooperating debtor (again, we refer to our companion piece on the academic debate on why countries repay).

Will Greece repay its creditors?

Our guess is that Greece will not, in the end, make large net repayments to its creditors and it is probably better if they do not have to. Hopefully the country will build on the hard-won progress of the early years of this decade and continue to advance to becoming an economically more developed country, ideally fitting in with the mainstream of the Eurozone.

There are three clarifications from the last few years that need to be cleared up, namely:

- First, contrary to widespread popular opinion, the net flow of funds (new loans and subsidies minus repayments) went from the Troika to Greece from 2010 to mid-2014, with a modest flow in the other direction after Greece stalled on its structural reforms;
- Second, the negotiations are very sensitive to which way net flows are going (Greece stopped playing ball as it approached going from being a net recipient to a net payer of new funds.); and
- Third, the threat points have little to do with Greek concern about maintaining a reputation for repayment – and this episode has much to say about the academic debate about why countries repay.

The Greek situation is a tragedy for Greece and a tragedy to Europe. Any resolution will need to have clarity about the direction of flows, both in the minds of policymakers and in the mind of the general public. As one can see from our attempt at clearing things up, this is no easy task.

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Footnote

[1] Greece's net subsidies from the EU amounted to roughly 3% of a depressed GDP in 2014. These funds count towards Greece's primary surplus, so a requirement that Greece run a primary surplus of much less than 3% (virtually sure for 2015 and probably until the next renegotiation) would actually mean that Greece would not have to generate any internal funds for debt repayment. About 13% of Greek debt is owned by domestic creditors, according to IMF estimates.