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Greece Under Enhanced Surveillance: Debt Relief vs. Moral Hazard

By Gikas Hardouvelis May 1, 2018

FILE - Former Minister of Finance of the Hellenic Republic (June 2014 to January 2015) Gikas Hardouvelis. (Photo by Eurokinissi/Yorgos Kontarinis, File)

Greece’s third Economic Adjustment Program 2015-2018 is coming to an end this August. Anticipation of the event has generated a heated debate within the country on what comes next. Will there be adequate debt relief as was promised back in 2012 and in 2016, and if yes which form will it take and under what conditions? Does August 2018 mark a “clean exit” from the past programs, followed by a period of uninterrupted growth as the governing coalition claims? Or instead, does it simply represent a “dirty” exit followed essentially by a disguised new “fourth program” with no fresh money from the lenders, yet with many extra restrictive obligations, some already legislated, as the main opposition parties proclaim?

The stakeholders in this debate are not only the Greek citizens, the domestic political parties or the central bank, but the lenders as well, who carry different points of view, different financial claims and different motives. Today it is still too early to predict the end result, yet it is clear a minimum consensus has emerged among the lenders that Greece will be under enhanced surveillance in the years to come, which would be stricter than for any other EMU country that went through an economic adjustment program.

The view of the Central Bank

The Greek Central Bank (and the ECB) has taken a strong position the country needs to enter a precautionary agreement with its European lenders in the form of an enhanced conditions credit line (ECCL) in order to safeguard its uninterrupted access to credit and, consequently, its smooth exit from the current program. The central bank claims that the funding for such a buffer exists and is cheap. It can originate from the unutilized funds of the third program. An ECCL would protect the country's finances and would also guarantee cheap ECB liquidity for the country's banks. It is a win-win situation.

This position has infuriated the government, which keeps an eye to the next national elections and has the ability to call them early, any time until September 2019. The government would like to have a free hand for some time prior to the elections in the allocation of public funds towards its preferred customer-voters, without any European auditors on its back. An ECCL would keep the lenders in the country, messing up its plans. It would also nullify the image of the country having successfully graduated from the past programs and from outside interference. And since the government itself has to ask for an ECCL for it to take place, the government will simply refuse to request one.

Debt relief and moral hazard

The discussion is particularly complicated by the promise made by the European lenders initially in November 2012 – then reinstated in May 2016 – of additional future debt relief in the form of short-term, medium-term and long-term measures. The short-term measures are already taken and have pushed EFSF and ESM bond maturities forward into the future by almost seven years. The medium and long-term measures will be taken at the end of the program, only if needed in order to make the debt sustainable and only if Greece has fulfilled all its obligations.

From mid-2015 onwards, a number of international think tanks and the IMF have come to the conclusion Greek public debt sustainability is feasible only under additional debt relief. Under reasonable economic growth projections, the size of debt servicing is way too high relative to the economy's future size. It requires further relief.

Greece also appears to have kept its part of the bargain for the promised debt relief. Leaving aside the disastrous 2015 when the new government collided with the country's lenders and aborted the 2014 growth take-off, the Greek government subsequently switched gears and by now seems to have almost delivered on the program requirements. It is about to finish with the last and 4th review of the program.

Today the open questions relate to the size of the required debt relief and more importantly, the method of delivering such relief without generating moral hazard on the side of the Greek government. If debt relief were given out front with no future conditionalties, the Greek government could easily fail to subsequently continue the reform effort and the fiscal austerity and, hence, the Greek economy could easily revert to its earlier imbalances, presenting a renewed Euro Area problem in the future. Discussions on those topics are on-going. And the stakeholders are many.

Markets ideally want debt relief out front

The first stakeholders are the private capital markets. Markets would like to be assured debt is sustainable in a credible fashion. To be able to lend to Greece at relatively cheap interest rates they ought to see a substantial debt relief out front with no strings attached. Any attempts to put conditions on the future delivery of such relief, particularly conditions related to future Greek policy actions (that reduce moral hazard), would lead them to doubt the relief itself, effectively raising Greek borrowing rates.

If Greece were to successfully exit the Program, it needs to have the financial markets on its side. Since mid 2017 it managed to issue 5-year and 7-year bonds at reasonable yields. It also successfully performed a bond swap that concentrated volumes at certain maturities, thus generating market liquidity. Following a series of – long delayed due to political uncertainty – credit rating upgrades, long-term yields have also come down to 4%. Yet market conditions are fragile and there is a long way to be covered for the investment grade credit rating. Recall, for example, that in late January when the US stock markets abruptly declined on a Monday, it caused Greek borrowing rates to temporarily rise by more than a full percentage point, when nothing similar happened in the rest of Europe. Fragility is here to stay unless markets are fully assured the debt relief is substantial and credible.

Different opinions within the Eurogroup; hardliners against what markets ideally want; the IMF as a possible wild card

The second major stakeholder is the Eurogroup, which needs to be assured Greece will follow through with fiscal primary surpluses and with structural reforms. The government may have delivered on the Third Program but there is a nagging suspicion – due to the lack of reforms' ownership – the moment lenders leave Greek politicians without tight supervision, they will decelerate the reform effort and go back to old leftist-populist slogans as well as spending habits. This suspicion is shared by the IMF and may not be completely unfounded. A primary example is the current experience with the country's post-August growth plan.

Instead of formulating a growth plan for the next five or ten years and offering proposals of how to tackle bureaucracy, how to re-engineer the public sector, how to expedite judicial decisions, how to bring investments into the country; instead of debating the growth plan publicly and generating a consensus in the country; the government apparently chose to send to Brussels a wish list of economic policy actions extracted from its early 2015 incoherent political campaign, which aims essentially to elevate its "leftist credentials" with its voter base. The plan was not made public. Yet many of those leaked actions, like raising the minimum wage, are perceived as indirect attempts to undo the reforms it was obliged to perform earlier under the program.

Hardliners in the Eurogroup are thus likely to insist that a substantial part of the medium term relief be delivered with strict conditions, which make the size of relief not only a function of external growth parameters like GDP growth, but of government actions as well. One tool to utilize over the next four years are the SMP/ANFA profits, which amount to close to four billion euro until 2022. This is free money for the Greek government, not a loan; hence any reasonable government has an incentive to continue the reforms in order to receive it. But for a scrupulous government the money is neither large not lasts long. Hence Eurogroup hard liners are likely to insist on additional stricter conditions, which also go beyond 2022.

Others within the Eurogroup are perhaps more understanding of the conflict between strict future conditions on Greek policy actions and the ease with which Greece can tap the financial markets. They are more willing to give the Greek government the chance to prove itself as a decent manager of the country and become the exclusive owner of reforms. And they are even discussing long –term measures of debt relief, which adjust the relief to the country's nominal economic growth (the so called French solution).

A consensus has to be reached soon. It is unclear what that would be. At a minimum it would involve enhanced surveillance. The IMF may also play a role too. The IMF clearly favors more debt relief, does not like policy-contingent measures, and is vocal about its position.

Yet at the same time the IMF appears deeply doubtful of the Greek government's ability to continue the reform effort. This is why it insisted the Greek government legislates long before the end of the program (in June 2017 to be implemented in 2019 or later) some features it considers essential for the stability and fairness of the tax system and the pension system. It pushed both items under the camouflage of fiscal consolidation, amounting to recurrent government savings of 2% of GDP. This is why it will not back out from its position, despite the huge primary surpluses the current thoughtless government has generated over the last two years (3.8%of GDP in 2016 and 4.2% of GDP in 2017, way above targets) by over-taxing the middle class and stifling any hopes of structural growth.

The optimal scenario for the country

The penultimate stakeholder is the country itself. The incentives of the country do not necessarily coincide with the short-term incentives of the current government. The country deserves immediate and substantial debt relief and, more importantly, a solid growth plan for the next ten years. Both are still missing. Both are subject to debate. We do not know the final outcome yet. What we do know is that some debt relief will take place and we can definitely forecast European enhanced surveillance attached to the relief. An effective growth plan may or may not materialize. But let us hope for the best.

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