Greece illustrates how the politics of lending can undermine its effectiveness

Why do bailout packages often fail to restore market confidence? Outlining results from a recent study, **Terrence Chapman**, **Songying Fang** *and* **Randall Stone** *write that creditor countries tend to have a special interest in the crisis country whose loans they are backing. Weaker conditionality applied to countries deemed to have high levels of importance, however, has counter-productive effects, with markets anticipating that easier access to credit may lead to further fiscal instability and recidivist borrowing. They argue that in the Greek case it will be difficult to rebuild the confidence of a market shaken by several failed attempts at stabilisation, and that the country will probably require another round of debt relief.*

The summer of 2015 marked another period of high drama in the ongoing Greek debt crisis. Amidst continuing negotiations with lenders and European leaders, Greek citizens rejected austerity conditions requested in exchange for yet another bailout by the Troika of the European Commission, the European Central Bank, and the International Monetary Fund. Shortly after the referendum, the staunchly anti-austerity Greek finance minister Yanis Varoufakis resigned and Prime Minister Alexis Tsipras' cabinet was reshuffled, ultimately leading to a call for new elections.

This summer's events generated a crisis of confidence in Greece's banking sector as well as renewed questions about its fiscal solvency and long-term participation in the Eurozone. The volatility also affected markets around the world, despite the Troika's efforts to stabilise the situation. Market uncertainty of this sort does not bode well for Greece's recovery, as even the most generous bailout packages typically must be accompanied by private sector investment in order for full stabilisation and recovery.

Indeed, a core function of multilateral lending is to ease market fears, halt capital flight, and pave the way for reinvestment. Yet repeated deals have failed to stabilise the situation and the latest will be the third major bailout since 2010. Why does multilateral lending sometimes fail to close the "financing gap," and why do bailout packages sometimes fail to restore market confidence?

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The politics of lending

In a recent study, we have tackled these questions. We start from the premise that multilateral loan programmes, like those issued by the IMF, or bailouts put together by the European Commission and European Central Bank, are backed by creditor countries that often have special interests in the crisis country. For instance, at the start of 2010, German and French banks faced considerable exposure to a Greek crisis. A Greek collapse would therefore deal a much larger blow to the European economy than would a collapse in a more peripheral country.

Similarly, U.S. bank exposure and geopolitical interests have been shown to be strongly associated with IMF loan size and conditionality. A powerful country like the United States is able to use various diplomatic levers to influence loan terms during negotiations with strategically pivotal countries. The result is that countries that are deemed of exceptional importance tend to get larger loans with fewer strings attached, and when they fail to implement mandatory conditions, they tend to face more lenient punishment.

What does all this mean for restoring market confidence? Our analysis indicates that political and financial ties to influential lenders can have countervailing effects. First, the very fact that countries are negotiating a bailout with the IMF can shake markets. This is the “adverse selection” effect of multilateral lending: countries only turn to the IMF when times are bad, so asking for help reveals bad news. Our analysis of sovereign yields in a sample of emerging markets from 1992-2002 confirms that the announcement of an IMF loan programme tends to increase yields, all else being equal.

On the other hand, important countries tend to get larger loans, and this injection of liquidity can assuage markets. A sovereign bailout can provide the means for countries to continue paying their bills in the short term, which temporarily relieves crisis conditions. Longer-term reform is usually necessary, however, to put the loan recipient on a firmer fiscal footing, and this is where loan conditions can play a big role.

Conditionality requires governments to implement adjustments to the policies that create large debt burdens in the first place. Our findings indicate that more important countries, on average, get fewer conditions attached to their loans, and this tends to undermine market confidence. Market actors anticipate that weaker conditionality may lead to future fiscal instability and recidivist borrowing.

Finally, the most important countries may face lax enforcement of conditionality. This creates a “moral hazard” effect: countries implement conditions only half-heartedly, knowing that even if the IMF finds them in bad standing, their importance to pivotal IMF principals means that loan suspensions will be temporary and short-lived. We find that markets may “price” this moral hazard effect in as well, as countries politically close to the United States face higher interest rate premiums even after controlling for loan size and conditionality.

The net effect of multilateral lending on the price of private market credit is thus composed of these effects. Large loans tend to depress bond yields, while weak conditionality and the anticipation of lax enforcement tend to increase them. The combination of these forces can lead to a “catalytic effect” on markets in some cases, but may also fail to restore market confidence, or even depress it, in others.

What does this all mean for the Greek crisis?

Our research suggests that in a situation like the Greek crisis, which threatens potentially far-reaching negative consequences in core EU countries, it is difficult to establish a loan programme that will restore the confidence of private-market actors.

First, the adverse selection effect of obtaining a bailout will shake markets. For Greece, a third bailout in five years signals that the Greek economy is in dire straits. At the same time, the importance of Greece to the Eurozone may signal that far-reaching reform that corrects the underlying mechanisms driving fiscal imbalance will be hard to achieve. Under such circumstances, it would be surprising if a new bailout were warmly welcomed by investors, and no one should expect the Greek debt crisis to be resolved by a 20 per cent reduction in principal.

However, there may be paradoxical good news hidden in the growing reluctance of publics in the core countries to extend Greece further support. As a result, the terms of loans have gotten tougher over the years, and have gradually come to focus more clearly on the structural reforms that Greece needs to make in order to achieve growth in the long run.

The hard bargain driven recently by the European Commission, and demanded by the German government, are signs of a new posture. The spectacle of the Greek parliament voting in favour of the deal offered in August even after the July referendum had rejected lesser austerity signalled a sea change. While Greece may still appear "too big to fail" to many investors, this perception has diminished since the first bailout in 2010, as banks in core European countries have moved to reduce their exposure to a Greek collapse. The result is that lending to Greece may now be more effective.

The seeming intractability of the Greek debt crisis does not imply that the Troika should forgo efforts to intervene. When countries have credibility problems, as the Europeans do in their dealings with Greece, it is usually because important interests are at stake. In this case, the long-term cost of solidarity with Greece will be lower than the net subsidies the U.S. Federal government transfers to Louisiana, and the idea of Europe is worth investments on a greater scale.

Rather, our study indicates that the politics of lending can sometimes undermine its effectiveness, and this helps to explain why success is so elusive in important cases. In the Greek case, it will be difficult to rebuild the confidence of a market shaken by several failed attempts at stabilisation, and it will probably require another round of debt relief.

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About the authors

Terrence Chapman – *University of Texas at Austin*
Terrence Chapman is Associate Professor in the Department of Government at the University of Texas at Austin.

Songying Fang – *Rice University*
Songying Fang is Associate Professor in the Department of Political Science at Rice University

Randall Stone – *University of Rochester*
Randall Stone is Professor of Political Science at the University of Rochester.

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