A giant leap for the eurozone – a small step for Greece…

Vassilis Monastiriotis

2011-8-1

The agreement reached in the 21/7 Eurogroup Summit is beyond doubt historic. For a first time the eurozone leaders moved towards a comprehensive response to the crisis, which addresses it not as a country-specific liquidity problem, or a problem of public finance management, but rather as a much wider solvency problem affecting fiscal stability in the Eurozone at large. The agreement is moreover historic because it provides an example (and a template?) for how institutional constraints, like those on national bailouts and central bank independence set by the Maastricht Treaty, can be overcome if enough political resolve and ingenuity is on the table. It creates essentially a permanent bailout mechanism which can operate, in political terms, independently of the ECB. What this means about the so-called primacy of monetary policy and for price stability in the eurozone remains to be seen. But the historic moment of the agreement is that it reflects an "it is politics, stupid" attitude: it is the moment when Europe becomes again the field where economic problems are offered political solutions – and not a technocratic arena where markets dictate politics.

But not all is historically epic. First, the decision takes us where we ought to have been in February 2010, when it first became clear that "the Greek problem" was not solely Greece's problem – and that its resolution required not only a return to fiscal discipline but also an aggressive restructuring of Greece's debt. When considerations about moral hazard, policy credibility, and adherence to rules where leading to an emergency loan conditional on an extreme programme of austerity measures, only to continue compromising policy credibility and adherence to rules and succumbing to moral hazard dilemmas. In this, the Greek debt was allowed to climb from 110% to 145% of GDP, bond spreads were let to reach preposterous levels and austerity measures were put in place that triggered one of the worst recessions in Greek history. The decision of 21/7 is indeed historic; but, sadly, the problem is now much bigger and the necessary measures much more costly.

An important aspect of the 21/7 deal is of course the sharing of the cost of the Greek debt restructuring with the private sector. According to –largely incomprehensible– estimates by the Institute of International Finance, the private sector effectively takes a 21% haircut. Although this sounds quite sizeable, it is in fact much lower than what most private investors have already accounted for in past or prospective write-offs (ranging from 30-50%). But bear in mind that, even with this 'haircut', nobody is set to lose any real money: private holders of short-term maturity debt will manage to get back their full investment-plus-interest, as the EFSF allows Greece to fully service its debt until 2014. The rest will suffer a reduction in the returns of their investment (by accepting a lower interest rate) or will accept a principal reduction in exchange of higher and more secure returns. The present value of the pay-back remains strictly higher than the actual investment, while all future investments are effectively fully guaranteed (the principal is guaranteed through a "credit enhancement" financed through the €109bn loan and the interest is guaranteed as long as Greece remains solvent). In fact, what the 21/7 deal does, above all, is to engineer an "orderly restructuring" that will be least painful to private investors (and European banks) and least disruptive for the European financial system. Profitability is maintained (nobody is expected to experience a negative return to their investment), no CDS payment is triggered (as rollovers remain strictly voluntary), no investor's cash-flow is compromised (because they can chose among a menu of options) and no "Lehman Bros" moment is initiated. This may be a seemingly costly solution, but it is one that is most convenient for the parties involved.

And for Greece? Greece gets two immediate benefits. First, it remains afloat for at least 2014 and hopefully well beyond that – provided that it manages to deliver on the fiscal and economic fronts (the "numerator" and "denominator" problems). Second, it remains firmly put into the common currency, as the deal makes any considerations about a "euro-exit" immaterial. But this is almost an optical illusion. Without additional policy efforts, even with the agreed debt restructuring the Greek debt will continue to grow – both in absolute terms and as a share of GDP. On the one hand, the Greek debt remains at non-manageable levels: despite the €109bn bailout and the €37bn haircut, the actual debt is only expected to be reduced in 2014 by some €30bn (€13bn due to the rollover,

another €13bn if the €20bn buy-back programme works and a few more billion by savings on interest repayments), while the guarantees for the principal of the rolled-over bonds may in fact add more to the debt than the envisaged savings. On the other hand, and more importantly, the primary deficit, which keeps fuelling the debt, remains – and so does the negative growth, which eats into the "denominator". What does the deal do about this? Not much, but at least it promises two things: to strengthen the fiscal consolidation efforts through the enhanced conditionality of the second loan and the provision of technical assistance by the Commission and the Member States; and to develop a series of actions to deal with Greece's growth problem.

On the fiscal consolidation front, it is not difficult to see that, no matter how necessary the external assistance may be, it is in essence a direct involvement in the management of public finances and public policies that may well spur –than overcome– domestic political tensions. What is perhaps more difficult to see is how this assistance will alleviate the disproportionate pain – relative to the fiscal gain – that the austerity measures and public sector restructuring, on which it will insist, have been – and will continue to be – causing to the Greek economy. Concerning the growth dimension, the most tangible measure seems to be the commitment to reducing Greece's national contribution to the Cohesion Funds and the advantageous pre-financing of this by the European Investment Bank. Again we are back to February 2010 – or earlier, as these are proposals the Commission and the EIB were openly discussing already in the summer of 2009. The much-discussed deployment of a "new Marshall Plan" is the second type of action envisaged, which is expected to help channel a series of strategic investments from European businesses to Greece. The reference to the historic "European Recovery Programme", although missing from the final text, is bold. But there is very little substance to it so far: the deal makes no explicit financial commitment; nor does it actually set-out a "Plan". A government-sponsored conference of business associations in Germany is a good start but it is a far cry from what George Marshall was devising in his time. If the "Plan" is to work, it will have to comprise of a set of large-scale, well-orchestrated and comprehensive interventions rather than a collection of ad hoc piecemeal actions.

To the sceptic, it seems that devising such a comprehensive plan has fallen victim of what is the main – albeit less advertised – element in the agreement's pro-growth strategy: the insistence on structural reforms. The deal makes it rather clear that eurozone's technical assistance will extend to the design and implementation of structural reforms to raise the competitiveness and flexibility of the Greek economy. This is not a minor departure from the logic of the original Marshall Plan: whereas the former was based on fiscal expansion to aid industrial restructuring, the current plan is very much rooted on the logic of market liberalisation and supply-side reforms. As the new IMF Managing Director put it after the summit, "it is time for Greece to get back on that trend of structural reforms, privatisation and fiscal consolidation" – no reference to a Marshall-type economic restructuring there.

One cannot help but think that, despite the "historic moment", the political economy of the approach to the crisis remains very much as it was before 21/7. Emphasis is first on dealing with the threat of contagion triggered by a Greek "disorderly" default (here, the job is pretty much done and the crisis is averted) and secondarily on instigating structural change in Greece (including market liberalisation/deregulation and public sector restructuring/downsizing). A Keynesian-type growth strategy for Greece and for Europe remains very much outside the set of policy options, as attention on fiscal discipline and price stability remains the key priority – and growth continues to be seen as the outcome of competitiveness-enhancing supply-side structural reforms.

In this sense, the 21/7 deal has not achieved much for Greece. Despite the "holistic approach" and the "bold solution" it is not unthinkable that Greece will return in February 2012 where it was in late June 2011 or in February-March 2010: still suffering from primary deficits and anaemic – if not negative – growth (as the demand-side will continue to shrink thanks to the continuing austerity), still having an unsustainable (as, almost paradoxically, the agreement alone does very little to actually reduce the level of debt) debt and still not fully meeting the conditions for the release of funds earmarked in the 'second bailout' (as this remains conditional on Greece's progress with reforms). What will Europe do if this turns out to be the case come 2012? Will it shift its priorities and emphasis from supply-side reforms and fiscal consolidation to pro-growth expansion through a Marshall Plan proper? Or will it insist on the strict implementation of the "no pain – no gain" motto which justifies further austerity and further deregulation

despite the recessionary impact of these?

Almost counter-intuitively, this largely depends on Greece. One way or another, the deal offers Greece a new lifeline, it gives her the time and space to “do something”, almost anything, to start turning the situation around. As long as Greece starts implementing *some* of the reforms and starts producing *some* outcomes, then the conditions will start becoming gradually milder and the option of paying increasing attention to the “denominator” will become more credible, allowing Greece a stronger voice on this. It is possible, but it doesn’t look good. And it will certainly turn uglier before it starts becoming better. The 21/7 deal is a giant leap for the eurozone; but sadly it is only a very small step for Greece…

Note: a shorter version of this text will be published in Athens News on 5 August