Centre for International Governance Innovation

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Greece: Playing with Matches in the Ammunition Warehouse

Miranda Xafa

Key Points

- The current standoff with creditors over the second review of the third bailout increasingly resembles the catastrophic 2015 negotiations that brought Greece to the brink of Grexit.
- The protracted negotiations are taking a toll on the economy. Depending on when agreement is reached — or elections are called — three possible scenarios could unfold, none of which involves Grexit.
- After the July 2015 referendum, Greek Prime Minister Alexis Tsipras presented the proposed program as an improvement over the one rejected by voters because it included debt relief and excluded the "tough" International Monetary Fund (IMF) from the troika. Now he will be asking Parliament to vote for tough measures for the exact opposite reasons.

The prolonged negotiations with official creditors to conclude the second review of Greece's third bailout increasingly resemble the catastrophic standoff with creditors in the first half of 2015 that led the country to the brink of Grexit. Back then, the newly elected radical left government led by Prime Minister Tsipras confronted creditors with demands for debt write-offs and an end to austerity. But Tsipras overplayed his hand, and the game of chicken — a standard model of conflict for two players in game theory — ended with political suicide: a third bailout agreement with harsh austerity measures, capital controls and a double-dip recession. "The lesson? A conciliatory tone will carry you much further than brinksmanship when you're making bold requests," according to Harvard Law School, which ranked Greece's "chicken" negotiating approach as the worst negotiating tactic of 2015.[1]

Tsipras has yet to internalize this lesson. Having spent an unprecedented 14 months finalizing the program's first review, he appeared determined to close the second review by the December 5, 2016 Eurogroup meeting, while also hoping to receive a firm commitment to debt relief that would enable Greece to be included in the European Central Bank's (ECB's) quantitative easing (QE) program. But the Eurogroup considered that Greece had not made sufficient progress on its reform agenda to merit debt relief, and called on Greece to continue negotiations

1 See www.ekathimerini.com/205022/article/ekathimerini/news/greek-negotiation-of-third-bailout-deal-tops-harvards-worst-tactics-list.

About the Author

Miranda Xafa is a CIGI senior fellow. She is also chief executive officer of E.F. Consulting, an Athens-based advisory firm focusing on euro-zone economic and financial issues. At CIGI, Miranda focuses on sovereign debt crises and drawing lessons from the Greek debt restructuring for future debt crises. From 2004 to 2009, she served as a member of the executive board of the IMF in Washington, DC, where she had previously worked as a staff member. Miranda served as chief economic adviser to Greek Prime Minister Konstantinos Mitsotakis, from 1991 to 1993. From 1994 to 2003, she was a financial market analyst and senior expert at Salomon Brothers/Citigroup in London. Miranda holds a Ph.D. in economics from the University of Pennsylvania and has taught economics at the Universities of Pennsylvania and Princeton. She has published several articles and papers on international economic and financial issues.

with the troika in order to reach agreement on fiscal measures that would achieve a 3.5 percent primary surplus target in 2018 and beyond. Days later, Greece's prime minister resumed his confrontational rhetoric and offered a handout to pensioners without consulting with creditors. With the level of trust at an all-time low, the short-term debt relief measures on loans provided by the European Stability Mechanism (ESM), agreed at the December 5 Eurogroup meeting, were put on hold. By the February 20, 2017 Eurogroup meeting, some measures were implemented to lengthen the maturity profile of Greece's debt due to the ESM — which constitutes the bulk of Greece's public debt — and to reduce interest rate risk, and agreement in principle was reached on measures to sustain the primary surplus beyond the program period.

The troika returned to Athens at the end of February in an effort to make progress toward completing the second review before €7.4 billion of debt service payments fall due in mid-July, which Greece will be unable to meet without external financing. Recognizing the political contraints euro-area creditors face, the IMF has accepted a 3.5 percent of GDP primary surplus target for a few years, although it would have preferred more growth-friendly budget targets with lower primary surpluses and higher debt relief. But while the Fund is flexible on the short-term budget targets, it insists on credible measures to meet those targets, including further cuts in pensions and a broadening of the tax base. Staff-level agreement can therefore be reached only after the Greek Parliament legislates pension and tax reforms, including a reduction in the tax-free income threshold that now leaves 55 percent of Greek taxpayers off the hook. The cuts would take effect in 2019 at the latest, to ensure compliance with the 3.5 percent of GDP primary surplus target in 2018 and beyond. To sweeten the pill, creditors have agreed to let the Greek government spend any excess after compliance with the primary surplus targets has been confirmed. The Greek government also needs to implement market-opening measures in the labour and energy markets, and make progress toward reducing non-performing loans (NPLs) that now amount to 45 percent of banks' loan portfolios. Further scrutiny over the coming weeks will focus on the 2016 primary surplus, which the Greek government claims exceeded two percent of GDP versus a target of 0.5 percent. The IMF doubts this surplus is sustainable, even if confirmed by Eurostat, not least because a large number of pending pension applications remain unrecorded. It has called for additional fiscal measures of two percent of GDP, over and above what was included in the original ESM program, to ensure that the medium-term primary surplus target of 3.5 percent of GDP can be reached and sustained. The Fund has agreed to revise its estimate of the fiscal gap if its projections turn out to be overly pessimistic.

After staff-level agreement is reached, the IMF is due to decide whether to participate in the program with financing, depending on whether the program "adds up" and European creditors agree to provide substantial further debt relief after the program is successfully completed. Conclusion of the review is also a prerequisite for Greek bonds to be included in the ECB's QE program, which should facilitate Greece's return to capital markets. All sides want to seal the deal so that creditors disburse the next tranche of the €86 billion bailout in time to meet the July 2017 debt service payments.

How was such a tough reform package arrived at, before creditors undertake any debt relief commitments, and only weeks after Prime Minister Tsipras claimed IMF demands were "unreasonable" and refused to take measures that would come into effect after the program ends in 2018? It is simply because the German and Dutch governments ruled out further disbursements under the current program unless the Fund participated. After German Finance Minister Wolfgang Schäuble hinted at Grexit in the absence of reforms, Tsipras returned to his familiar chicken game, going as far as to say that he was confident the German government "would not let an arsonist play with the matches in the ammunition warehouse" (Tsipras quoted in Kourtali 2017). But if anyone is playing with fire, it is Tsipras. After reshuffling his government in early November 2016 to help expedite the review, he claimed that Greece had fulfilled its commitments under the program and reminded European creditors that "pacta sunt servanda," a Latin phrase often used by Schäuble.[2] However, a letter from Finance Minister Euclid Tsakalotos to the Eurogroup revealed in January that his government had implemented only one-third of the prior actions for the second review.[3]

Tsipras is torn between accommodating creditors' demands to avoid default and placating his electoral base through fiery anti-austerity rhetoric. The result of this schizophrenic agenda is a constant sense of chaos in the negotiations, with apparent progress one day turning into confrontation the next. Throughout 2016, Tsipras' selling point was that although he had to take tough measures to conclude the first review, he managed to protect basic pensions and shift the tax burden to "the rich." This narrative went out the window after the IMF insisted on cuts in basic pensions and in the tax-free income threshold to meet the fiscal targets. Even if lower fiscal targets beyond 2018 are eventually agreed on between Greece and its European creditors, the IMF insists that the cuts are necessary to help reduce high corporate and income taxes that have caused a mass exodus of taxpayers to other jurisdictions, and to roll out the Minimum Guaranteed Income program nationally — a pilot social program targeted to the truly needy (IMF 2017).

With his popular appeal largely removed from the world of reason, Tsipras has now proclaimed the end of austerity by arguing that the new measures will be fiscally neutral, insofar as every contractionary measure would be matched by an expansionary one — although this would happen only to the extent that Greece overperforms its fiscal targets. This hyperbole drew cheers from his rapidly dwindling support base, but it is not acceptable to creditors. Euro Working Group Chair Thomas Wieser said at a conference in Delphi on March 5 that the review could be concluded as early as Friday, March 10. Sadly, this was not an oracle but a conditional statement subject to the Greek government's willingness to give up politically driven demands and to act quickly.

Tsipras played with fire when he gave a €620 million (0.3 percent of GDP) handout to pensioners in December without consulting Greece's creditors. Now it is up to him to decide whether he will put out the fire, fan it further or let the show go on until July. His focus on reaching a deal that is palatable to his support base implies that the talks could drag on. He needs to strike the right balance between two conflicting considerations. On one hand, tough measures will further erode his popularity, with eight in 10 Greeks already disappointed by the government's performance and with the conservative opposition New Democracy party

2 See www.kathimerini.gr/881193/article/epikairothta/politikh/perikopha-kondyliwn-gia-xwres-poy-den-dexontai-prosfyges-zhta-o-tsipras.

3 See www.capital.gr/o-petros-lazos-grafei/3190158/tsakalotiada-se-pliri-exelixi.

now leading the polls by a wide margin.[4] On the other, prolonged uncertainty undermines the recovery and raises the risk that a fourth bailout and bank recapitalization will become necessary. Real GDP has yet to return to its 2014 level and leading indicators point to further weakness.

Under these circumstances, there are three possible scenarios, ranging from benign to adverse:

- → **Benign:** Staff-level agreement is reached by late March and the review is concluded at the April 7 Eurogroup meeting in Malta, or by teleconference before the next Eurogroup meeting on May 22 (after the second round of French elections on May 7); the IMF agrees to participate and the ECB agrees to include Greece in QE.
- → **Moderate:** The review is not concluded until late May or mid-June (there is a Eurogroup meeting on June 15), with IMF participation and ECB inclusion in QE. The delay will take its toll on the program's optimistic 2.7 percent GDP growth projection for 2017, and may require additional measures to reach this year's 1.75 percent primary fiscal target. Also, continued uncertainty will further erode banks' deposits and capital base.
- → **Adverse:** The review appears unlikely to be concluded before mid-July. In this scenario, Tsipras may use public anger at the creditors' demands, fuelled by pro-government media, to trigger a snap general election in early July (reminiscent of the referendum he called in July 2015), knowing that he will lose, but hoping to remain a player as opposition leader. To avoid Grexit, European creditors provide a bridge loan to cover the July payments (as they did in July 2015), and negotiate a fourth bailout agreement after the September election in Germany. The new bailout would be funded by the unutilized funds of the €86 billion third bailout, which currently stand at €54.3 billion, as further funding is highly unlikely to be approved by European parliaments. Of this total, the IMF has advocated setting aside €10 billion for bank recapitalization due to the delay in reducing NPLs.

The irony is that when Tsipras asked Parliament to give him the authority to negotiate with creditors after the July 2015 referendum, which resulted in a "no" vote, he tried to sell the proposed deal as an improvement over the one rejected by voters because it included debt relief and excluded the "tough" IMF from the troika. Now he will be asking Parliament to vote for tough measures for the exact opposite reasons. Populism at its best!

4 See www.ekathimerini.com/216163/article/ekathimerini/news/poll-puts-nd-way-ahead-of-syriza-shows-discontent.

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CIGI Publications

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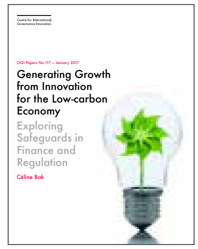
Essays on International Finance, Volume 4
Beatrice Weder di Mauro and Jeromin Zettelmeyer

The global financial safety net has expanded from barely more than one institution — the International Monetary Fund (IMF) — to a much larger, although geographically patchy, web comprising the IMF, regional financing arrangements and central bank swap lines. This essay analyzes the issue of the incentives that this creates for sovereign borrowers and private borrowers and lenders and makes recommendations that would help to reconcile crisis lending with good incentives in the new multipolar environment.



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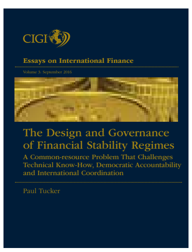

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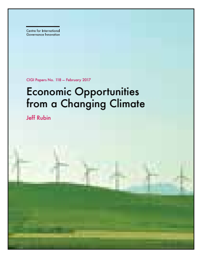

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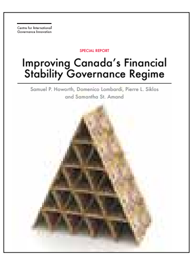

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Special Report
Samuel P. Howorth, Domenico Lombardi, Pierre L. Siklos and Samantha St. Amand

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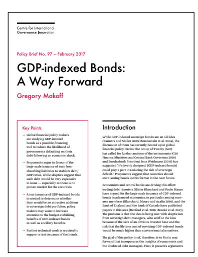

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CIGI Policy Brief No. 97
Gregory Makoff

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