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The return of the Greek problem

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Summary

- Although the 'Eurozone question' for Brussels has moved on to the details of banking union and the handling of a likely future Spanish bailout, Greece remains the most volatile part of the Eurozone picture, and it is about to come to boiling point again.
- Greece is going to impose substantial further costs on its Eurozone peers – either in the form of an expanded bailout on revised terms, a debt write-down for other Eurozone sovereigns, or by leaving the euro and throwing the Eurozone into crisis.
- This is because Greece's debt burden is simply unsustainable. Yet of Greece's creditors, only the ECB and Eurozone states are in a practical position to take losses on their various holdings. The ECB has refused any such losses. The only real question is how and on what terms Eurozone governments will choose to pay the Greek bill, and whether they can sell this choice politically.

  As undignified as it might be, Greece is negotiating from a position that has a number of perverse strengths. As insurmountable as it is for Athens, Greece's total debt is still less than 3.5% of Eurozone GDP. Politics aside, it can be sustainably written off. It cannot be sustainably paid back.

On the face of it, Angela Merkel was taking a political gamble by going to Greece this week. Greek Prime Minister Antonis Samaras had probably expected his invitation to get no further than the Chancellery in-tray. The mood on Greece in Germany has soured notably over the summer. Yet Ms Merkel deliberately chose a show of solidarity with the embattled government of Antonis Samaras, despite angry protesters and a hostile Greek media.

Ms Merkel knows all too well that although the 'Eurozone question' for many in Brussels has moved on to the details of banking union and the handling of an inevitable Spanish bailout, Greece remains the most volatile part of the Eurozone picture, and it is about to come to boiling point again. The Troika report on the state of Greece's public finances has now been postponed until November, after the US elections, and it will be grim reading. Ms Merkel must also know that simple and unavoidable arithmetic means Greece is going to impose substantial further costs on its Eurozone peers – either in the form of an expanded bailout, a debt write-down for other Eurozone sovereigns, or by leaving the euro and throwing the Eurozone into crisis. The only real question is how and on what terms Berlin, Paris and the rest of the Eurozone will choose to pay the Greek bill, and whether they can sell this choice politically. Ahead of this week's European Summit it is worth setting out why this is the case. Ms Merkel went to Athens knowing that Greece is her problem as well as much as Mr Samaras'. This Global Counsel Insight explains why.

Long term bad

Since his government took power in June Mr Samaras has been confronted with a grinding deterioration of Greek growth and Athens' fiscal position. Greece has now experienced five years of recession and is forecast to endure a sixth. Output will fall by almost 7% this year. The Greek state, even after three years of cutting, is still running a

deficit of 9%. The Greek public debt will be nudging 180% of GDP by the end of 2013.

In the last six months Greek government revenue has collapsed due to stalling growth and an apparent taxpayer reluctance to hand over monies during the long hiatus between functioning governments between May and August. The collapse in revenues has wiped out the bulk of Athens' previous savings. The Samaras government argues that it needs two additional years to deliver on its Troika reform commitments against these deteriorating conditions.

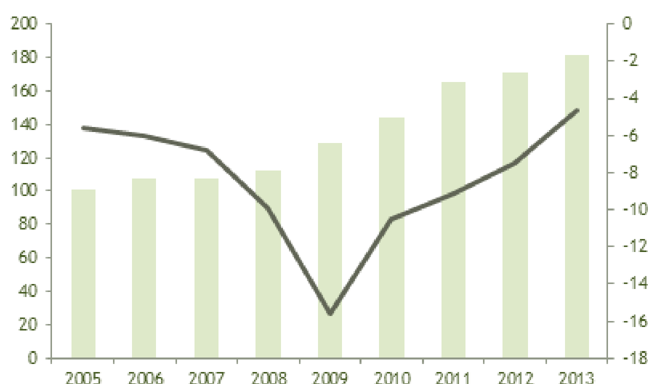

Chart 1: Greek debt as % GDP (LH) and deficit as % GDP (RH)
Source: IMF

In the meantime, it will need €31bn before the end of the year to cover the shortfall in debt service and government expenditure costs. The question is whether this will be forthcoming and what, if any, price will be extracted from Athens in return. IMF officials in both Athens and Washington have become increasingly chary of the long-term impact of its Greek involvement on their reputation for objectivity, and have taken a much firmer line than Brussels.

The IMF has insisted publically on further cuts to public sector pay and pensions. It is also insisting on heavy cuts in areas where Finance Minister Yannis Stournaras has a direct say over spending rather than satellite ministries. Last week Stournaras conceded cuts in farmers' pensions and public servants' holiday bonuses.

Athens has agreed to frontload spending cuts in a way that aims to achieve a primary budget surplus of 1.1% in 2013. Yet Mr Samaras and Mr Stournaras are sitting atop a system whose capacity to deliver this kind of retrenchment is open to serious question. The ambitious Greek commitment to €50 billion euros in corporate and real estate privatisations by 2015, for example, looks simply undeliverable. Moreover, even if it was achieved, it would barely staunch the Greek haemorrhage.

With debt markets closed to it, Greece will need similar support in some form every year until at least 2020. Mr Samaras typically describes the €31 billion hole as a liquidity problem – without it both public salaries and debt interest will go unpaid. But in reality, the assumptions that are required to believe that Greece is still even approximately solvent are extraordinary.

Even after the major restructuring of its debt to private creditors in March 2012, Greece is still paying 3-4% of its GDP in interest costs. The IMF calculated earlier this year that it needs to run surpluses of 2.5% or more from 2014 just to prevent its debt dynamics getting stuck in a downward spiral. Even with significant surpluses above 4.5%, Greece's debt will still be well over 100% of GDP by the end of 2020.

This is the equivalent of asking a distressed and combustible Greek society to hand over a significant chunk of its output to its foreign creditors for a decade, and still end up crippled by debt. Given the context of sluggish growth, whatever the *bona fides* of Mr Samaras, Greece's indebtedness simply looks like an unsustainable economic and political drain on the resources of a society already running 25% unemployment.

Whose hair, cut how?

This suggests that the only real question is how and when that debt burden is restructured or defaulted on. Greece is in debt to five groups of institutions: private foreign institutions; Greek banks and money market funds; the IMF; other EU governments; the ECB. Four fifths of private sector holdings of Greek debt were wiped out by the private sector write-down negotiated in March 2012.

The resulting residual €58 billion in debt is now structured under English law which makes it much harder to renegotiate. The fact that nominal yields on Greek debt have fallen by a third since April suggests that private investors are fairly confident that next time the pain will fall elsewhere. Long-dated Greek debt trades at 28.7 cents in the euro, which is a substantial discount, but still above the 13.9 cents it cost in May.

Greece's banks and money market funds hold a further €66bn in sovereign debt, but are in many cases so weak that the shock of a sovereign default would only provoke a deeper crisis by requiring a massive recapitalisation to prevent the Greek economy from stalling completely. The price of forcing Greek banks to take a haircut on their sovereign debt would be the collapse of the Greek economy.

This leaves public institutions. The IMF does not take haircuts. So unless Greece defaults on its debts by leaving the euro, it will have to happen through a voluntary restructuring of the €181 billion in debt or loans held by the European Financial Stability Facility, European states and the ECB.

The ECB has said that it is not prepared to take any losses on its own €55 billion stake. To do this, it claims, would constitute an indirect fiscal transfer and would therefore be illegal. The ECB has said that it would not expect ECB investments in Spanish or Italian sovereign debt to be treated as senior to any private sector debt holdings, but it is clearly not willing to extend the same terms to Athens.

The simple reason for this, apart from the fact that losses on Greek debt are imminent, and losses on Spanish and Italian debt remain very much hypothetical, is politics. Mario Draghi's calculation is no doubt that his institution is already extended to the limits of its political mandate and needs a line in the sand somewhere. After a year of extending his own balance sheet on behalf of Europe's political leaders, he will also want to push the ball back into their court.

Chart 2: Composition of Greek sovereign debt (millions)
Source: Commerzbank

Which is where it will land for this week's European summit, or the summit in November that will consider the Troika report. European member states are caught in a trap: either the rest of the Eurozone pays up and keeps Greece afloat, or it needs to find a politically acceptable way to restructure its own holdings of Greek debt. Making further bilateral or EFSF loans when the integrity of the existing loans from these sources is in question has a somewhat perverse quality to it. Nevertheless this is probably what will happen. Paris has already signaled that it supports the idea of extending Athens' Troika programme obligations over a longer time frame. Madrid and Rome will fall in behind Paris.

Senior voices in the German parliament have warned Ms Merkel that the Bundestag will not support a relaxation of Greece's terms, or further disbursements. Something, however, has to give. But to secure any kind of leeway Athens will have to look like it is taking the medicine. The tough measures announced by Athens since the summer will no doubt be presented as evidence that Greece is being made to pay for any latitude. Merkel made a point of public support for Mr Samaras in Athens but probably privately advised Mr Samaras that he would do well to look like he is being squeezed hard.

When weakness is a strong hand

But in the medium-term Athens knows that as undignified as it might be, Greece is negotiating from a position that has a number of perverse

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strengths. As insurmountable as it is for Athens, Greece's total debt is still less than 3.5% of Eurozone GDP. Politics aside, it can be sustainably written off. It cannot be sustainably paid back. Mr Samaras must have calculated this, just as he has calculated that Greece's exit from the Eurozone remains a risk his sovereign peers are not willing to take.

Although the ECB's liquidity guarantees for Spain and Italy provide a measure of protection against contagion, a disorderly Greek exit from the Eurozone would have unpredictable and potentially devastating consequences. Ms Merkel has reckoned that any exit from the Eurozone would create a precedent that would permanently affect investor perceptions of the integrity of the Eurozone, almost irrespective of attempts to prevent contagion. Her visit to Greece was in part a way of signaling that for all the loose talk from Germany over the summer recess about a Greek departure, Berlin is not willing to contemplate such an outcome.

At some level Mr Samaras knows that if this is the case, then Berlin, Paris and the other EU creditor states, and probably the ECB, are going to have to accept a restructuring of their loans and holdings of Greek debt. If next week's summit or the summit in November do not concede this – and they almost certainly won't – then it will only be because it has decided that €31 billion that it is unlikely to see again is an acceptable price tag for kicking the Greek can down the road.

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