The Greek debt crisis and its misconceptions

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The public debate on the recent Greek debt crisis is characterized by inaccuracies and misconceptions that draw the wrong conclusions.

Nikos Garganas' book[1] points out many of these inaccuracies and misconceptions. The author recounts the causes of the crisis and highlights the wasting of the fiscal space that resulted from the drastic reduction of interest rates, due to the elimination of exchange rate risk after Greece's entry into the Eurozone. The huge savings achieved from the reduction in debt servicing costs were spent on benefits. From 2000, when the country's entry into the Eurozone was approved, until 2007, when the global financial crisis erupted, expenditure on pensions increased significantly, the state bloated, and the debt increased in the name of a bogus, and ultimately disastrous, 'pro-people' policy. Greece prospered on debt-financed spending, which was squandered without upgrading the productive base.
When the global financial crisis erupted, countries heavily dependent on foreign borrowing, such as Greece, could no longer find willing investors. Although some claim that Greece went bankrupt in 2010, the crisis was already preordained in 2009, when the Karamanlis government literally ramped up government spending in a desperate attempt to stave off recession, pushing the deficit to 15% of GDP.

While the crisis was unfolding, with bond spreads rising and the country's credit rating falling, a major weakness in the Eurozone architecture was revealed, namely, the lack of a mechanism for managing fiscal crises in member states. Initially, the EU invoked the 'no bailout' clause (Article 125 of the Treaty), but subsequently, when Greece lost access to capital markets and bankruptcy was imminent, fears of a domino effect that would drag other vulnerable eurozone countries down with it, prevailed. Thus, in May 2010 we arrived at the 1st Memorandum, funded with €110 billion (half of Greece's GDP), from the IMF and from bilateral loans from Greece's European partners, before the European Stability Mechanism was created. These amounts were unimaginable by the standards of the time – and even of today – as they far exceed the financial support ever given to any country globally, reflecting Greece's gigantic macroeconomic imbalance. Countries resort to the IMF with deficits of 5% of GDP. We waited until it was revealed that the deficit was 15% of GDP.
I now come to the debt issue. The IMF agreed to participate in the programme although it could not confirm that the debt was sustainable, as is normally required for any large loan from the institution. This was due to European opposition – mainly from the ECB – to a debt restructuring, which was thought to increase the risk of contagion. When the programme derailed in its first year of implementation and fears of Grexit escalated, a decision was reached to impose a haircut on the bonds held by private investors, which was finally implemented by the Papademos government in March 2012. That was the so-called PSI (Private Sector Involvement), with a 53.5% bond haircut, the largest debt restructuring in the history of sovereign bankruptcies – a debt write-off of €106 billion, equivalent to 1/3 of the public debt. The book concludes that the PSI was a wrong choice, because it damaged the country's credibility and the economy, by harming confidence and bank deposits, and imposing high costs on the banks that held about 1/3 of the Greek government's bonds (p.190, 208). Here we disagree with Nicos:

In the first instance, there was no alternative. The Europeans made the PSI a precondition for the 2nd Memorandum because they had no intention of bailing out private bondholders with European taxpayers' money. Everyone agreed (p. 241) that the debt was unsustainable, thus having Greece continue to borrow from the European partners to pay off the private investors was not a solution.

Apart from that, the PSI had a positive (albeit short-lived) impact on the spreads and bank deposits, based on the data for March and April 2012. If things deteriorated thereafter, it was because early double elections were called for May and June, in which radical left SYRIZA emerged the 2nd largest party. It then took the tripartite Samaras government several months to agree on the measures that would meet the targets of the 2nd Memorandum. Obviously, the program was derailed, and it took debt relief from the Europeans, debt buybacks from private investors (with a further haircut), and a revision of the program's targets to get it back on track.
Finally, as far as the banks were concerned, the PSI simply recognized pre-existing losses, as the Greek government bonds they held were trading at 1/3 of their nominal value in the secondary market. After the PSI, the banks were

recapitalised with loans from the official sector and financial stability was restored.

It is worth noting that the debt restructuring achieved by the PSI did not only involve the haircut on the face value of the existing debt, but also the swap of existing bonds for new bonds with much lower interest rates (starting from 2% and reaching 4.3% over time) and longer maturities. The overall restructuring significantly improved debt sustainability, which was a precondition for agreement on the 2nd Memorandum. Without the PSI and the 2nd Memorandum, the country would have been unable to repay outstanding bonds that were maturing in the first half of 2012 at their face value. The result would have been disorderly default and Greece's exit from the Eurozone. Moreover, the fear of contagion due to the PSI was not borne out. The crisis had spread to Ireland and Portugal well before the PSI. The risk of contagion does not stem from timely debt restructuring; it stems from the uncertainty created by its delay, as reflected in bond spreads. The key to preventing a crisis from spreading is to find a credible solution to the problem of debt sustainability.

What happened next is well known. As soon as the five-year recession ended and Greece returned to the markets in 2014, SYRIZA came to power with unrealistic promises of ending austerity and securing a new debt write-off in order to bring the crisis to a definitive end. This was a convenient narrative that shifted the responsibility for the return to normalcy to the creditors, while overlooking the reforms Greece needed to implement to improve competitiveness and balance the budget.

A one-off debt reduction in the absence of growth and fiscal consolidation does not lead to sustainability. The book talks about the costs that citizens had to suffer as a result of the long and ineffective negotiation with creditors, which rekindled Grexit fears, plunged the economy back into recession, and led to a shutdown of the banking system, the imposition of exchange controls, a new bank recapitalization with borrowed money, and finally a 3rd Memorandum.
In closing, I want to briefly refer to the myths that the book refutes. During the crisis we often heard – even from the most senior officials – that the memoranda created the crisis, and that debt relief would end austerity.

Debt relief would not end austerity. Even if the entire debt were cancelled from the outset, the primary deficit, which stood at €25 billion (10% of GDP) in 2009, would still have to be eliminated, simply because no one was willing to lend us that amount in perpetuity. Adjusting to lower levels of consumption and borrowing would therefore have been painful anyway, with or without debt relief.

The memoranda did not produce the crisis, instead the crisis produced the memoranda. The drop in GDP was inevitable because the pre-crisis standard of living had risen far beyond the economy's ability to support it. The funding that accompanied the memoranda limited the recession, which would have been much deeper if Greece had to eliminate its huge primary deficit

immediately. The inevitable drop in living standards would have been much more rapid and dramatic, as the state would have been unable to pay wages and pensions. Contributing to the 25% fall in GDP during the crisis was the choice of successive governments to reduce the deficit by cutting public investment and raising tax rates on a narrow base, and to avoid implementing reforms (due to political costs) that would have improved competitiveness. An example would be the opening of professions and goods markets to competition, which would have reduced the high costs of living we face today.

Nikos Garganas' book helps the reader understand the causes of the crisis, the difficulties that arose in addressing it, and the problems it bequeathed us. Unless there is a common understanding of the causes of the crisis and of the major structural reforms needed to get us out of the quagmire once and for all, the necessary social consensus for such reforms will not be reached. This book contributes to such a common understanding. By keeping the memory of the crisis alive, the book also helps to avoid another crisis in the future, by pointing out that even after the very generous contribution of creditors, the crisis has had a devastating effect on living standards and per capita income, which today remains below where it was 15 years ago.

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[1] "Greece's Sovereign Debt Crisis and its Economic Aftermath", Kerkyra Publications, February 2024.