Greece and the IMF: Who Exactly is Being Saved?

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Introduction

On May 9, 2010, a joint mission of the IMF and the European Commission concluded negotiations on a loan package to be provided to the Greek government. The amount of these loans as well as the volume of the adjustment effort that is to be delivered by Greece is staggering. In return for an (additional) 30 billion euro austerity program, Greece will receive 80 billion euros of European bilateral loans and 30 billion euros of IMF loans over the next three years.

The view widely held in policy circles is that this loan package, even though it implies very tough cuts, will ultimately save Greece and its economy from financial market speculation.

This paper takes a closer look at the Greek adjustment program and arrives at the opposite conclusion. Three years from now, Greece will be facing an even higher debt burden. Meanwhile, jobs and economic growth will have been sacrificed. The only thing the rescue package really achieves is a major change in the ownership of debt. With Greek sovereign debt being transferred from the balance sheets of banks to the balance sheet of European governments, the real purpose of the entire operation is to save European banks by relieving them from holding debt titles upon which a potential default could be looming.

The Background: Serious Homemade Policy Errors

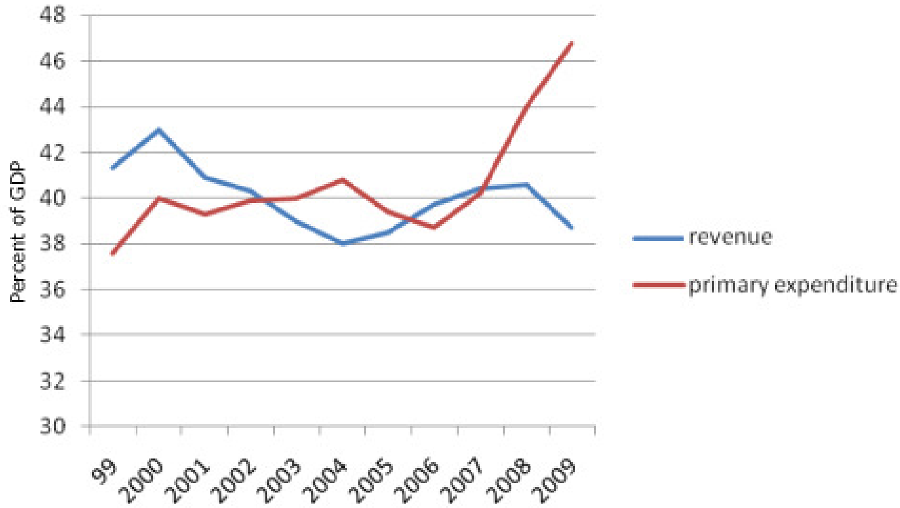
Economic policymakers in Greece have made serious policy mistakes in the years preceding the crisis. Fiscal policy was pro-cyclical; revenue declined substantially from 2000-2004, despite annual GDP growth averaging 4.5 percent during these years. Taxes, already below the European average level (around 44% of GDP), were slashed. Public spending rose rapidly after 2007, mainly in response to the economic slowdown and then recession (see **Figure 1** below).

Moreover, previous Greek governments were not fully reporting these trends in national statistics. With the help of Goldman Sachs, financial operations involving derivatives were developed so that debt and deficits could be downplayed and Greece could qualify for Euro Area membership. Public finances are also struggling with corruption and tax evasion, both believed to be widespread.

It is against this background that the Greek government, newly arrived in office, decided in favor of reporting correct deficit and debt numbers. In October 2009, the deficit for 2008 was revised upwards from 5% to 12.5% of GDP while the projected deficit for 2010 also went up from 3.7% to 12.5% of GDP and later to 13.6% of GDP.

Financial markets did not appreciate this effort at transparency by the newly elected Greek government. Nor did the public warning of the central bank governor of Greece for banks to be careful in buying Greek sovereign debt and using it as collateral in liquidity operations with the European Central Bank go down well. From November on, Greece was hit by several speculative waves, bidding up the interest rate on sovereign debt to exorbitant levels, at times exceeding 10%.

FIGURE 1
Revenues and Primary Expenditure



Source: OECD (2009).

The Joint IMF/Commission Policy Package

Finally, at the beginning of May, a joint mission from the IMF and from the Economics and Financial directorate of the European Commission (DG Ecfin) was called in to negotiate a loan rescue. In return for access to a 110 billion euro pool of loans over the next three years, Greece had to commit to a package of 30 billion euros of fiscal cuts implemented over the period from 2010-2014. These cuts are equal to 11.1% of annual GDP, with 5.3% of GDP coming from expenditure cuts and 4% from increased revenue. Structural reforms of the tax system (tackling tax evasion) and the expenditure process (tackling corruption) would yield an additional 1.8% of GDP by the end of the program (see **Table 1**). Adding the 5% of GDP of structural measures already decided under European peer pressure over the previous months makes for a total consolidation package equal to 16% of annual GDP.

TABLE 1
Overview of the Fiscal Consolidation Package Agreed with the IMF and the European Commission

	Revenue (% of GDP)	Expenditure (% of GDP)	'Structural reforms' (% of GDP)	Total (% of GDP)	GDP (implicit in the program, in billions of current euros)
2010	0.5	2.0	N/a	2.5	231
2011	3.0	1.1	N/a	4.1	224
2012	0.8	1.7	N/a	2.4	228
2013	-0.3	0.5	1.8	2.0	235
2014					242
Total	4.0	5.3	1.8	11.1	

Source: IMF.

Looking closer at the adjustment program, one finds that the goal has been to eliminate as quickly as possible the primary deficit (i.e. the difference between taxes collected and non-interest expenditure). The substantial cuts implemented in 2010 will indeed have the effect of slashing the primary deficit from 8.6% of GDP in 2009, to 2.4% in 2010, and 1% in 2011 (see **Table 2**). In other words, if Greece is allowed to continue to run deficits in the following years, this deficit spending will be entirely attributable to interest payments on outstanding debt.

TABLE 2
Greece: Medium-Term Fiscal Strategy (% of GDP)

	2009	2010	2011	2012	2013	2014
Primary balance	-8.6	-2.4	-0.9	1	3.1	5.9
Overall deficit	-13.6	-8.1	-7.6	-6.5	-4.9	-2.6
Interest	5.0	5.6	6.6	7.5	8.1	8.4

Source: IMF.

Table 3 provides some more detail on the exact consolidation measures Greece has committed itself to. Besides hiking value added taxes, the adjustment program focuses on reducing the government wage bill. The various measures regarding public sector employment (eliminating Easter, summer and Christmas bonuses, heavily reduced replacement of retiring workers with new hires, cuts in transfers to public enterprises) are to deliver close to 2% of GDP. This is topped off with cuts in social benefits amounting to 1.5% of GDP (elimination of pension bonuses, a nominal pension freeze, means-testing of unemployment benefits). Tax policy is also used to tax highly profitable firms (0.3% of GDP) and to introduce 'presumptive' taxation of professionals. Meanwhile, the IMF also claims that its measures are designed to protect the most vulnerable: therefore low-income public sector workers will continue to receive means-tested bonuses and the VAT increase on foodstuff is limited to 1%.

TABLE 3
Effect of Selected Consolidation Measures on the Deficit in 2013 Relative to 2009

	% of GDP
Revenue measures	
VAT rate increase by 10%	0.8
Broadening VAT base	0.7
Excise tax on fuel	0.2
Gaming royalties	0.3
Levy on high profits	0.3
Presumptive taxation of professionals	0.2
Expenditure measures	
Cutting bonuses and allowances	0.7
Workforce reduction (an additional 20,000)	0.5
Eliminate pension bonuses	0.9
Nominal pension freeze	0.2
Means test unemployment benefit	0.2
Cancel second installment solidarity allowance	0.2
Cut intermediate consumption	0.4
Cut transfers to public enterprises	0.7
Cut investment spending	0.7

Source: IMF.

Cuts without Growth: A Policy Doomed to Fail

A fiscal contraction this of size will have a substantial impact on economic activity and jobs. The IMF's staff report confirms this by projecting a contraction of 4% of GDP in 2010 and a continued shrinking of economic activity by 2.6% in 2011. In 2012 the economy is projected to pick up again, but the recovery would be exceedingly weak, with growth projected at 1.1 percent. After 2012, the IMF projects that the economy will expand in real terms at a rate of 0.94 percent annually.. With this growth scenario, according to IMF projections, by 2015 Greece still does not reach its 2008 level of real GDP.

Moreover, it may very well be the case that the IMF is underestimating the recessionary impact of fiscal consolidation. For example, it seems unlikely that the Greek economy would grow again at a rate of 1.1% in 2012 at the same time as an additional fiscal squeeze equal to 2.4% of GDP is being administered.

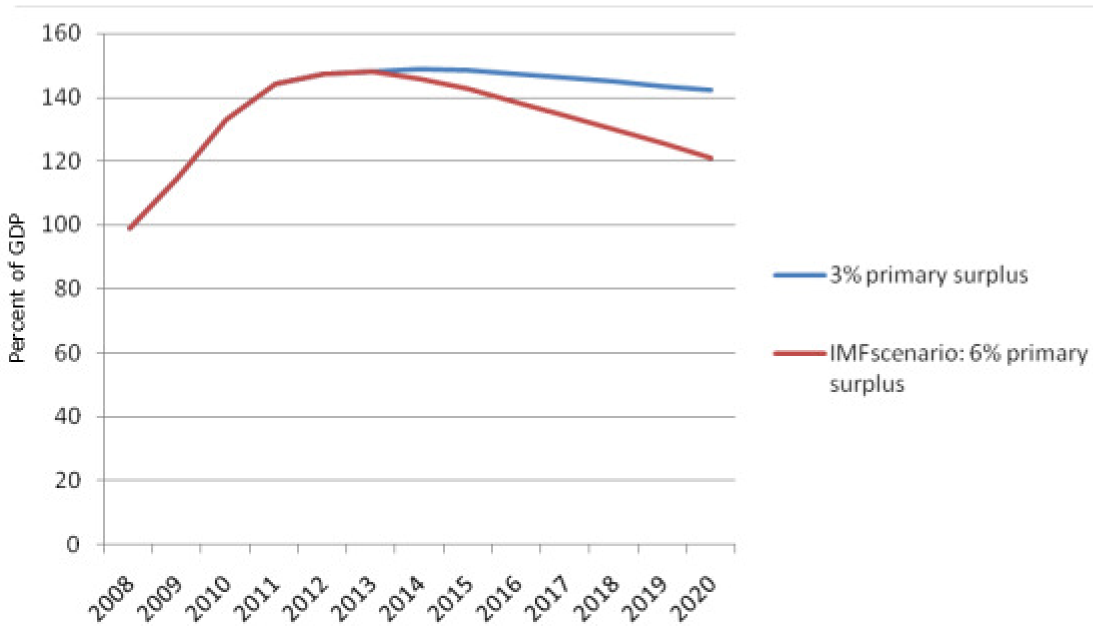
However, one does not need to question the growth projections to obtain dismal outcomes on the labor market. Even in the relatively optimistic growth scenario of the IMF, employment would fall by 6 percentage points and hardly recover by 2015. Unemployment is projected to rise from 9.4% in 2009 to 14% in 2013/2014.

Importantly, the initial collapse and following standstill in economic activity and nominal levels of GDP is also extremely bad news for the strategy of fiscal consolidation itself. On the one hand, to keep on servicing interest payments (see above), nominal debt will continue to go up. On the other hand, nominal GDP goes down and tends to stay down. This interaction between a rising numerator (nominal debt) and a stagnating denominator (nominal GDP) will result, according to the IMF itself, in a sovereign debt ratio of 145% of GDP by 2014, compared to a ratio of 115% in 2009.

Moreover, the picture is not really brightening up afterwards. **Figure 2** below shows the mechanics of debt over the long run. One line traces the evolution of the debt ratio as calculated by the IMF. The IMF does this by assuming a trend rate of 4.3% nominal growth, an average interest rate on public debt of 5.9% and, importantly, a primary surplus of 6% of GDP to be reached in 2014 and remaining firmly at this level from then on. In this scenario, the debt to GDP ratio would fall but only gradually. In 2020, debt would still be at 120% of GDP, well above the level where it was before the crisis (99% in 2008).

The IMF's scenario of debt dynamics is highly dependent on reaching a primary surplus of 6% of GDP. As can be seen from Table 2 above, the primary surplus is expected to jump from 3.1% of GDP at the end of the IMF program in 2013 to 5.9% in the following year. However, the IMF does not specify which measures are to be taken in order to obtain this additional increase in the primary surplus. The IMF may be counting on the possibility that structural reforms (improved tax collection) may improve public finances by this amount. It is also possible that the 3 percentage points of additional primary surplus were simply added to improve the longer-term outlook for the dynamics of Greece's debt. The second line in Figure 2 shows what happens to debt dynamics if the primary surplus does not increase to 6.0 percent of GDP as the IMF assumes, but remains at 3%. The long-term debt dynamics become even more dismal: debt climbs up to over 148% of GDP and remains over 140% even at the horizon of 2020.

FIGURE 2
Debt as percent of GDP under and after the Adjustment Program



Source: IMF and author's calculations.

This long drawn out process of unwinding sovereign debt raises the crucial question of whether Greece will be able to regain financial market confidence in time, i.e. by 2014. From that year on, Greece will have to return to the markets and find the financial means to pay back the 110 billion euro loan rescue package, representing some 40% of Greece's GDP. On top of this, Greece will also need to repay those debts that are set to come due in the rest of this decade. With debt having exploded to a level of 145% of GDP, it is likely that financial markets would continue their refusal to roll over Greek debt, thereby reviving the specter of exceptionally high interest rate charges bankrupting the state and the economy.

The fact that financial markets already seem skeptical does not bode well. Immediately after the announcement of the loan rescue package, interest rate spreads on Greek sovereign debt came down from extremely high levels. However, the interest rate on 10-year Greek bonds has since moved up again. By mid-June, it stood at 9.5%, almost four times the interest rate on German bunds. On top of this, and according to newspaper accounts, savers continue to take funds out of the banking system and out of the country, placing deposits mainly in Cyprus and the UK.

This vote of 'no confidence' should not come as a big surprise. Even if financial markets often behave in an irrational way, they do understand the basic principle that in order to repay debt, one needs to be able to generate sufficient revenue. They also understand that a policy of slashing deficits can be self-defeating. Negative feedback effects from deficit cuts to economic activity, and from there to lower than expected tax revenue, can force the economy into prolonged stagnation. This stagnation will make it more difficult to repay debt, especially if it is associated with deflation and therefore falling nominal revenue flows. With economic activity as well as prices being pushed downward by aggressive fiscal cuts, the denominator effect of falling GDP pushes an already high debt ratio even higher.

Financial markets may reasonably fear that Greece, through excessive austerity, will trap itself in a prolonged period of stagnation and deflation. As a result of its membership in the Euro Area, there is no escape route in the form of a currency devaluation or looser national monetary policy. No fiscal consolidation program however ambitious or aggressive is able to address these concerns.

What the Greek Rescue is Really About: Exchanging Debt Ownership to Save European Banks and Creditors

The IMF and the European Commission surely have done similarly calculations. They must recognize that it is unlikely that their rescue package will leave Greece's finances on a sustainable path.

In this way the package is not consistent with a standard IMF structural adjustment program that is supposed to be fiscally credible, thereby restoring the country's access to financial markets. In this case, the IMF and the Commission likely recognize that their adjustment program, despite its harsh measures, will not restore financial market confidence. This could explain the increase in the size of the package from the 40 billion euros on May 1 to the 110 billion euros in the final package. Given the calendar of debt repayments coming up, it was probably thought necessary to boost the volume of the loan package to Greece to 110 billion so that Greece would be taken out from the global financial marketplace for the next two to three years.

This raises the core issue of the so called rescue package: If market confidence is not being restored while the Greek economy is at the same time being pushed into recession, double digit unemployment and rising poverty, then what is the point? Who or what exactly is being saved?

In the end, the purpose of the rescue package may boil down to a huge shift of debt from (mostly) private banks into public hands. The 110 billion euros now being lent to Greece by the IMF and European governments will be mainly used to pay back the banks and institutional investors who are now holding Greek debt. Banks, insurance companies and pension funds are the real beneficiaries. The possibility of Greece defaulting on the payment of interest and principal that is due should now be excluded for the next three years.

There is a clear European dimension to this, given the fact that the major part (almost 80%) of Greek sovereign debt is not in the hands of the Greek financial system but rather is in the balance sheets of German, French and UK banks (see **Table 4**). Europe and the IMF are not so much providing Greece with fresh finance but, most of all, shielding the European financial system from up to 200 billion euros of losses that could result from a Greek default. Curiously, almost one quarter of Greek debt is located in the UK (and Irish) financial sector. The obvious beneficiaries of the Euro Area governments' package are not Greek workers and citizens who will suffer from severe budget cuts and recession, but financial centers such as the City of London.

TABLE 4
Structure of Ownership of Greek Sovereign Debt

By country		By institution	
UK/Ireland	23%	Banks	45%
France	11%	Fund managers	19%
Germany/Switserland/Austria	9%	Pension funds	14%
Italy	6%	Asset management	10%
Scandinavia	3%	Hedge Funds	5%
US	3%	Central Banks/governments	5%

Source: Natixis. Flash 2010/218.

Conclusion: The Broader Picture in the Euro Area

The Greek consolidation and reform program as developed and imposed by the IMF and the DG Ecfin is contradictory. Despite tough sacrifices being demanded from Greece, the policy program will not address the key problem of getting sovereign debt dynamics under control. At the same time, with a policy of generalized cuts in the pipeline (public sector cuts, pension cuts and cuts in private sector wages), Greece could fall into a period of prolonged stagnation coupled with deflation.

However, since Greece is a member of the Euro Area, there is a risk that the stagnation and deflation imposed on Greece may spread through the rest of the currency union. Financial speculation has spilled over into the rest of the Southern periphery of the Euro Area in the aftermath of the Greek crisis. Euro Area governments together with the European Central Bank decided over the weekend of May 10 to set up a European Financial Stability initiative. Its logic is identical to the Greek adjustment policy exercise: In return for financial support (possibility of 750 billion euro bilateral loans, ECB directly buying sovereign debt) to financially distressed governments, Euro Area member states pledged to turn around their fiscal policy stance and introduce austerity measures.

A string of governments, including Spain, Portugal, Italy, France, and Germany, have announced ambitious cuts in deficit spending with public sector jobs and wages being a prime target. Meanwhile, the IMF is increasing verbal pressure on the issue of more wage and labor market flexibility (see for example the conclusions from the article 4 IMF mission Euro Area). The biggest cuts announced so far have been in Spain, where the government already decided to cut public sector wages by 5% and to raise the age of retirement. If Spain would indeed be forced to apply to the European Financial Stability Initiative to get access to European money, the IMF and DG Ecfin would get an opportunity to deliver a powerful blow to those labor market institutions (public services, social benefits, collective bargaining, minimum wages) on which the European Social Model rests. As is the case with Greece, this policy is also unlikely to get Spain's finances in order, nor will it succeed elsewhere in the Euro Area. Extreme fiscal austerity is only likely to lead to prolong economic stagnation coupled with possible Japanese-style deflation.

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