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Greece far from safe even after debt swap

By Willem Buiter and Ebrahim Rahbari

On Sunday night, as Athens burned, the Greek parliament voted to approve an omnibus bill. It contained the main elements of an agreement with the Troika on fiscal austerity, privatisation and structural reform, and the recapitalisation of Greek banks. Was this a ‘make or break’ moment for Greece?

A rejection of the deal by the Greek parliament, a disorderly Greek sovereign default and euro area exit would certainly have been disastrous for Greece. Not only would the Greek financial system have probably collapsed in weeks or even days but the transition period to a new drachma would in all likelihood have been chaotic and the resulting very large currency depreciation more painful than stimulating.

But even the Greek parliamentary “yes” is little more than a minor milestone on a long road. Many steps are needed just to avoid disorderly default on the impending bond repayment of €14.4bn in late March.

The Greek government needs to find an additional €325m in spending cuts and the leadership of the main Greek parties needs to commit in writing to stick to the agreement even after the next Greek election before the eurogroup signs off on the agreements (likely this week).

That would still leave parliamentary approvals in Austria, Germany, Finland, the Netherlands and Slovenia and the timely completion of the debt swap with the private creditors (the German vote will probably take place on February 27).

Even if disorderly Greek default is avoided on March 20 (our base case), Greece is far from home safe. The agreement includes additional austerity measures and a debt swap that – under very optimistic assumptions about economic growth and fiscal deficits – would reduce Greek general government (gross) debt to 120 per cent of gross domestic product by 2020.

If the present agreement holds out, the hope in about eight years’ time is that Greece is in a similar position to that of Italy today. But without Italy’s high level of private wealth.

If that does not sound daunting enough, remember that the previous agreements between Greece and the Troika were not short of over-optimistic projections and unfulfilled promises. What was missing? The determination and capability to implement the agreed fiscal and structural reforms and privatisation measures. The current agreement does little to resolve the implementation problem. It is therefore highly unlikely to materially address the lack of effective control by the Greek government over public spending, fundamental weaknesses in public administration (including but not limited to the tax bureaucracy), insufficient savings by Greek households and an uncompetitive non-bank corporate sector. Expecting the agreement to correct these longstanding weaknesses would be a tall order.

The experience with the first Troika programme in Greece over the past 18 months has shown that a solution to the challenges Greece faces cannot be imposed from abroad. It would have to be supported by a broad coalition of the willing in Greece, of which there is little evidence. But until such a coalition materialises, Greece will at best live from review to review in the eurozone. Over the next few days and weeks, investors will undoubtedly greet signs of a greater likelihood of a final signing off on the second bail-out agreement and a completion of the debt swap with minor relief rallies, while retreating at each sign of possible breakdown.

But even with a debt swap, the Greek situation is likely to return to the markets' attention in a few months at the latest.

After weeks of improving market sentiment following the European Central Bank's three-year long-term refinancing operation in December, the unresolved Greek crisis should be a timely reminder for investors that the euro area sovereign debt and banking crisis is far from over. The LTRO has merely bought the euro area time to finally get its act together. Fiscal deficits are at best slowly declining; sovereign debt continues to rise in most euro area countries; the EU banking system remains undercapitalised; a euro-wide recapitalisation facility for banks is still missing; the ECB is unwilling to put its mouth where its money is and admit that it stands ready, directly and indirectly, to act as lender of last resort to sovereigns as well as banks.

There is some good news. Plentiful ECB liquidity has pushed back the risk of disorderly default of systemically important euro area banks and, combined with financial repression in euro periphery nations, has eliminated the near-term risk of a disorderly default by a systemically important sovereign. The external damage caused by a Greek euro area exit (or 'Grexit', as we call it) could, given appropriate policy response from the ECB and euro area creditor countries, be limited and need not trigger waves of "exit fear contagion" to other fiscally weak peripheral countries. The second LTRO on February 29 may buy more time but until the fundamental drivers of the euro area sovereign debt and banking crises are addressed, volatility will remain a constant companion and recovery and growth absent friends.

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