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Greece on the Brink: Déjà Vu, All Over Again

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OVERVIEW

Bottom line: Greece and its creditors are again locked in a showdown over reforms, cash, and debt relief. Another cliff-hanger ahead of heavy July debt payments looks likely. Extend-and-pretend is a dead end for Greece and an increasingly populist Europe, and a more ambitious agreement seems ruled out by bailout fatigue in creditor countries. Markets are once again underestimating the risks of "Grexit."

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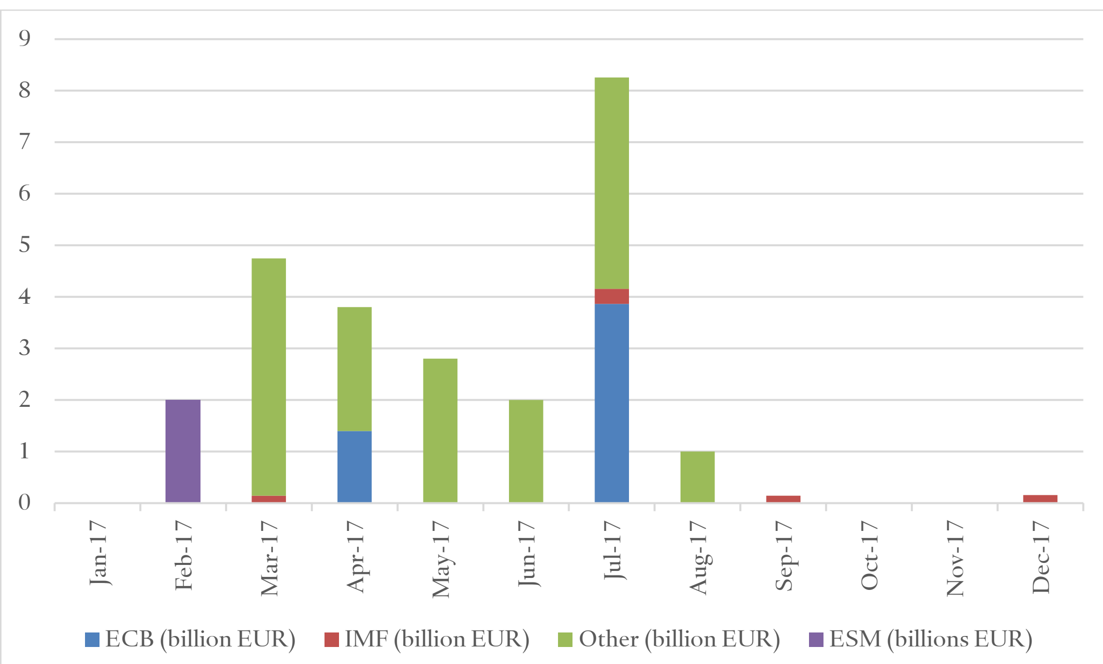
The Greek government's negotiations with Europe and the International Monetary Fund (IMF) once again occupy the front page of the papers, and all parties appear to have learned little from past exercises. Ahead of a March 20 meeting of Eurogroup finance ministers, Greece is resisting reforms to pensions, labor and product markets, and fiscal policy that would unlock the next tranche of assistance and pave the way for negotiations on debt relief at some unspecified future date (certainly after German elections). Creditors are resisting a concrete commitment to debt relief that could mobilize support in Greece for reforms, while the IMF is criticizing both sides and threatening to withhold its endorsement (and financial support) of any deal. Most likely, the standoff will continue until July, when $7 billion in debt payments is due to the European Central Bank, the IMF, and private creditors (see figure 1). Greece appears to have neither the will nor the resources to make those payments, so avoiding default will require European creditors to disburse from their existing loan programs.

FIGURE 1. GREEK DEBT REDEMPTION SCHEDULE IN 2017



Data source: European Stability Mechanism.

The expectation that, as in the past, Greece and its creditors will reach a deal at the last minute has provided support to markets. Most investors I talked to also assume that the IMF will soften its opposition to a kick-the-can deal and agree to come along in some form. But short-term agreements to provide more cash for incremental reforms—while deferring concrete decisions on debt—mean that a durable solution to the Greek crisis is becoming more remote. From the start of the Greek drama in 2010, successive Greek governments have prioritized fiscal adjustment while deferring the fundamental structural reforms to the economy that would allow Greece to be competitive in the eurozone over the long term. As a consequence, growth remains anemic (even by the standards of an underperforming eurozone), unemployment is sky high, support for continued adjustment is collapsing, and Prime Minister Alexis Tsipras's governing majority is shrinking. Recognizing his diminished room to maneuver, Tspiras has hardened his resistance to additional austerity. The deal investors expect is not a deal for Greek growth.

THIS TIME IS DIFFERENT

Although there will be a strong hint of déjà vu to this story for most readers, there are a few elements different from past negotiations. The first is that the IMF has taken a much firmer stance against the current program, and its fire has been aimed at both the creditors and the debtor. The IMF has been sharply critical of Greece's structural reform effort, including the country's reliance on temporary tax measures, a continued massive pension deficit, and its desire to roll back earlier reforms to collective bargaining. But the IMF has also attacked European creditor governments for unrealistic program assumptions and not committing to long-term debt relief. This stance between the two sides—on the one hand attacking the ambitious fiscal targets proposed by creditors as unrealistically austere and unlikely to be achieved, and on the other hand pointing out that more realistic fiscal targets will produce unsustainable levels of debt—has made IMF enemies all around. And, in contrast to past negotiations, the IMF appears to be quite dug in this time.

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The second new element is the rising populist backlash against continued bailouts in the European Union (EU). I have argued in the past that the primary risk to European economic policymaking may not be the risk of anti-EU parties coming to power but how those rising nationalistic pressures constrain policymaking across Europe and make an agreement among the major countries (much less unanimous agreement across all members of the eurozone) increasing difficult. Such is the case here. Notably, it is extraordinarily difficult for a Dutch or German policymaker, pressured by anti-immigration and anti-EU sentiments at home during an election period, to make precedent-setting concessions to Greece on debt. Those same election pressures create incentives to avoid the chaos that would accompany Grexit, but they also limit the capacity to agree on innovative solutions that would provide hope to Greeks.

Late last year, I was convinced that a breakthrough was possible. Greece would commit to additional reforms and European creditors would provide a long-term commitment by capping interest payments. This guarantee would be provided by the European Stability Mechanism (ESM) and would represent a transfer of resources to Greece. Specifically, if interest rates remained low the guarantee would not come into play, but if rates rose the ESM would cover the difference between the cost of funding Greece and the capped rate.

Viewed from the perspective of today's markets, this would be a backdoor fiscal transfer from creditor countries to Greece in expected value terms, which would give the IMF (and hopefully markets) confidence that Greece's debt profile would remain sustainable. I still see merit in such an approach, but against the backdrop of Europe's challenges, the odds of reaching an agreement during the current electoral cycle seem increasingly remote.

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The public summary from the IMF board's most recent meeting on Greece showed unusual candor regarding the extent of disagreement among major countries. Reading through the IMF's coded language, it is clear that the U.S. government and many others back the IMF's tough line on the negotiations, which has angered European governments. For the U.S. government in particular, this represents a sharp break from the Barack Obama administration, which pushed for continued IMF involvement. It is unclear at this point whether the change reflects the views of the Donald J. Trump administration, but I would not be surprised if, once the new team is fully in place, the United States takes a tougher stance against large but weak IMF programs. If the IMF is serious in its new firm line on Greece, it may find a strong ally in the Trump administration.

CONCLUSION

All of this suggests that, for economic and political reasons, the window may be closing on a comprehensive resolution of Greece's crisis. I would not bet against a deal to buy time, though probably without the involvement of the IMF. With each showdown, the risk increases that the Greek government will decide that its economic future is better outside the eurozone.

Looking Ahead: Kahn’s take on the news on the horizon

Brexit

UK Prime Minister Theresa May’s government is confident the Brexit bill will be passed by the parliament unchanged, and May still plans to trigger Article 50 before the end of March. But the invocation will likely not occur until late March, and formal talks with the EU will not start until mid-May, further exacerbating the uncertainty of the Brexit process.

French Presidential Election

While recent polls suggest Francois Fillon or Emmanuel Macron to be elected in the incoming French election, a surprise victory of Marine Le Pen remains a risk.

China

The Chinese government has lowered the annual growth target to around 6.5 percent. The shift of focus to containing the risks of high leverage to financial stability is important. However, more tangible results of economic liberalization, such as reforming state-owned enterprises, are necessary to sustain the growth momentum.