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“Can strong fiscal adjustments work in Europe? Putting the Greek case into perspective”¹

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Greece entered the ESM financial assistance programme in August 2015. This third adjustment programme for Greece again entails significant fiscal consolidation measures. Not only some previous Syriza government members, but officials and academics, as well have claimed that imposing harsh fiscal consolidations on Greece is a tremendous mistake. They contend that these only aggravate the country’s situation, and make people suffer needlessly without providing an economic cure. They therefore maintain that a massive debt write-down is indispensable to providing Greece with a viable economic path forward. I will put these claims into perspective, demonstrating that the view that Europe is replicating past mistake ignores a set of fundamental facts. Examining these facts sheds a different light on the path chosen. Without any doubt, there are always lessons to be learned. Yet, Europe did much more to cure the situation through its adjustment approach and financial support than this criticism acknowledges. It helped Greece return to growth by providing it with the necessary and viable fiscal space for this process to take place.

The strategy of addressing large imbalances through fiscal consolidation and structural reforms was necessary, and it has worked. Many had doubts whether an economic strategy requiring internal devaluation through economic policies, including fiscal consolidation measures, could actually work in a monetary union. Programme countries – that is Ireland, Greece, Spain, Cyprus, and Portugal – all largely restored the competitiveness they had lost in the years prior to the crisis, by addressing the gap that emerged between them and Germany, most evidently, in unit labour costs. Structural reforms improved the functioning of product and labour markets and increased overall growth potential. Decreasing imports, and importantly, better export performance closed current account imbalances. Again, this phenomenon holds across the board for countries including Greece. The improvement started in 2013. Greece experienced a strong push in exports with a growth rate of 10% in 2014. Countries set out on a renewed path of growth as broadened domestic demand followed stronger exports. For the current year, Ireland, Spain, and Portugal are expected to

¹ I would like to thank Aitor Erce and Daragh Clancy for their support in preparing the presentation accompanying this note and for valuable discussions based on their ongoing research project. Empirical evidence and references to the literature are provided in the slide presentation unless indicated otherwise.

outperform aggregate euro area economic growth; Cyprus, which is in an earlier phase of adjustment, is seen putting the recession behind it. In 2014, before the episode of economic uncertainty started, all international institutions projected that Greece would be among the high-growth countries in the euro area in the coming years. Growth projections for the current and coming years stood between 2.5% and 3%.² The OECD projects a longer-term potential growth of more than 2% over the next decade.³ The current downturn in Greece results from the political uncertainty and an impasse with creditors that prevailed over the past year, a period which the recent election has now brought to a close. Restoring the reform path in a credible manner will also help ensure a return to growth.

Greece faced a more difficult adjustment process than other countries, given high structural rigidities and public sector leverage, but it has made considerable progress toward balancing the budget and improving investment opportunities. Compared to the other peripheral countries, the public sector was highly leveraged at the start of the crisis, and the public deficit was unsustainable at 15% of GDP, while private sector indebtedness was fairly low. By any standard, this situation clearly required very strong fiscal consolidation. But the Greek economy also displayed certain structural characteristics that made it more difficult for it to digest a consolidation than for others implementing structural adjustment programmes. An extensive literature deals with this topic. It is now widely accepted that fiscal shocks during recessions have larger fiscal multipliers than at normal times. All programme countries, however, faced recessionary episodes and nonetheless recovered more quickly. This includes Cyprus, the economy which was most likely the hardest hit by the initial adjustment shock. A second factor is trade openness. The Irish economy's openness clearly aided its adjustment, while the Greek economy is more comparable to those of Spain and Portugal. Greece's real exchange rate depreciation, for example, was of the same order of magnitude as Ireland's. While this depreciation supported Greek competitiveness, the economy was unable to draw as much advantage from it as Ireland. Another factor is the structure of the fiscal consolidation; evidence suggests that fiscal multipliers are higher for taxation-based consolidation. In this respect, the Greek experience does not differ significantly from that of other programme countries.

A key difference emerges when one examines the economy's structural rigidities. Greece had much more elevated barriers to trade and investment than other peripheral countries. Judging by the well-known OECD structural indicators, when the crisis began, they were more than three times as

² European Commission, Second Adjustment programme Fourth Review
http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp192_en.pdf

³ See OECD (2014) Economic Outlook, Growth Prospects and Fiscal Requirements over the Long-run (Chapter 4), table 4.1, Paris

stringent as in other peripheral economies. By comparison, Greek labour market rigidities were less severe than in Portugal but slightly exceeded those of Spain and Ireland. Through the reform process Greece has taken significant steps towards removing trade and investment barriers. Greece effectively emerges as a reform champion in legislating necessary changes. The OECD figures clearly suggests that the reforms removing investment and trade barriers should continue, aiming to ensure that Greece catches up with other programme countries. The current ESM financial assistance programme, as detailed in the Memorandum of Understanding, front loads the implementation of these reforms. Overall, the Greek economy appears more resilient now to any fiscal shock than at the start of the crisis. Critics' who judge planned consolidations wrong are overlooking this shift, or structural break, brought about by programme reforms.

European support was vital in facilitating the adjustment process and generated substantive fiscal space. When a country cannot finance itself on the market at sustainable rates, the need for external support is evident. Without such support, a country cannot refinance and would at some stage have to default vis-à-vis its creditors. But the economic effect is yet more extensive, because external support creates the fiscal space needed for fiscal policy to stimulate the economy. Where a country faces a sudden stop, meaning that foreign investors shorten their exposure to the country, any fiscal stimulus would evaporate if the domestic banking system was required to finance it. The public sector would crowd out the private sector on a massive scale, wiping out any positive economic impact. In such a situation, lending under the concessional terms provided by the European crisis resolution schemes provides much needed fiscal space. The EFSF and ESM pass on their low borrowing rates, based on their top creditworthiness, plus a small margin, to the beneficiary country. According to ESM calculations, these rates meant a fiscal burden on the Greek budget more than 4% of GDP lower in both 2013 and 2014, than if it had had to finance itself on the market.⁴ This lending substantially eases the budget constraint the Greek government faces in the short run and allows fiscal policy to operate more effectively. These numbers are significantly smaller for other programme countries, as EFSF and ESM support represents less of its overall debt, but some positive benefits apply.

European financial assistance programmes represent a paradigm change in crisis support and require, in turn, a change in the accepted standard debt sustainability metric. Debt sustainability is a key concept of IMF and ESM financial assistance. Both institutions can only provide financial assistance if debt sustainability can be achieved. When a country faces a debt overhang, this can

⁴ See ESM Annual Report 2013, Table 1, p. 22, Potential savings of EFSF/ESM financing vs theoretical market cost in 2013; and 2014, and ESM Annual Report 2014, p. 29, How Greece benefitted from European debt relief. Both reports are available at: <http://www.esm.europa.eu/publications/reports/index.htm>.

generally be addressed through growth enhancing policies, fiscal consolidation, debt restructuring, and concessional lending. Fiscal consolidation is therefore required in all assistance programmes. When sustainability cannot otherwise be achieved, the IMF will require a debt restructuring prior to providing financial assistance. During the European crisis, this practice was applied to Greece. The private sector debt restructuring, which some observers criticised as “too little, too late” represents the biggest debt restructuring in modern economic history. It led to a massive nominal write-down of private debt by 54 % and around 75% in net present value (NPV)⁵ terms.

A key difference between IMF and European crisis support lies in the terms of financial assistance. The IMF normally only finances amounts that represent a small portion of national debt. It does so on standard terms, with a significant margin, and repayable within 10 years. By comparison, EFSF and ESM lending is provided on a larger scale and at more flexible terms, which can be calibrated to a country’s needs. European crisis support now represents: 4% of public debt for Spain; close to 20% for Ireland and Portugal; 28% for Cyprus, and; somewhat above 60% for Greece, of which 45% is held by the EFSF and ESM. The maturity of these facilities varies substantially between 15 years for Spain and 32.5 years average weighted maturity for Greece. In the course of the crisis, the terms of European lending were repeatedly modified for Ireland, Greece, and Portugal by lowering margins, and interest rate deferral for Greece, and extending maturities. From a Greek perspective, these reprofiling measures applied to its European loans amount to a debt reduction of close to 50% in NPV terms when market discount rates are applied.⁶ The combined effect of low EFSF/ESM financing rates, interest rate deferral, and long maturities mean that despite Greece’s very high debt level, it faces a lower annual interest burden than many other peripheral European countries.

Under these conditions, standard metrics for debt sustainability need to be adjusted to longer horizons and focus more clearly on refinancing needs. Clearly, basic solvency relations must hold and a highly indebted country must embark on a declining debt path. But the sufficient condition is not whether a certain debt level is achieved after 10 years, the standard horizon for the IMF. The risk that a country cannot refinance itself in the market and faces a renewed liquidity shortage declines substantially. This combined with the country’s commitment to growth enhancing reforms and prudent fiscal policies, gives confidence to investors and facilitates market access, despite an overall high debt level. Therefore, the flexible EFSF and ESM lending terms the make the refinancing level a more relevant criterion than the debt level for an assessment of a country’s debt sustainability. Put differently: it makes more sense to look at Greece’s gross financing needs that comprise interest

⁵ NPV translates into today’s money the value of future payment streams.

⁶ See ESM Annual Report 2014, p. 29, How Greece benefitted from European debt relief, available at: <http://www.esm.europa.eu/publications/reports/index.htm>.

rate, debt redemption payments, and costs for the budget deficit. Looking at the Greek situation from this perspective shows that calls for a massive nominal haircut on Greek debt as the only sustainable solution are unwarranted as they are still based on an old logic. They do not capture the fundamental structural change implied by the flexible EFSF and ESM lending terms and the high proportion of official debt held by countries.

To conclude, Greece has embarked on an ESM programme, the third adjustment programme for the country. The earlier programme – in line with the experience in other European countries – succeeded in reversing imbalances and creating a growth-conducive environment through structural reforms. The current situation faced by Greece will require some further fiscal consolidation, because European official sector support has already provided the maximum fiscal space possible in the medium term, without engaging in any direct budgetary transfers. These consolidation efforts will, however, be of a smaller magnitude both because of the progress achieved to date, and because the economy will be less negatively impacted through a better investment and trade environment. Claims that the third programme is repeating past mistakes disregard fundamental structural facts on the progress achieved so far.