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The Greek Debt Tragedy: An Ongoing Odyssey

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The Greek debt crisis has attracted a great deal of attention in recent years. Looking forward, however, there seems to be little hope that the continuous debate about how to deal with the country's debt burden will be silenced any time soon. In fact, when another tranche of about 5 billion € comes due this July, the Greek government will have to find new rescue money to avert yet another default on its debt[1]. The country's ongoing financial turmoil has not only increased social unrest and political uncertainty but has left the Greek economy devastated. Since 2009, its output has declined by a staggering 29% with no end to the negative trend in sight. This number easily compares to the figures from the Great Depression that afflicted Europe and the United States in the 1930s. Now, more than six years into this demoralizing debt drama and despite numerous rescue packages being issued, Greece's deficit stands at an unbearable 320 billion euros, which is roughly 1.8 times its total economic output.[2] In addition to the ongoing economic crisis, Greek citizens have endured severe political and social anxieties, which have led to the imposition of capital controls, several social riots that left three people dead, a soaring unemployment rate, hairbreadth escape votes and referendums as well as repeated threats of default and even forceful debates about an Eurozone exit. Given the country's current turmoil, one can rightfully ask: How could it ever come this far?

To answer this question, it is important to discuss the macroeconomic implications of introducing a common currency for all Eurozone member states to understand why Greece could build up such high levels of public debt and why an effective rescue plan has been so difficult to implement.

A common currency fixes exchange rates between countries at parity, which favours competitive and therefore more productive economies, such as Germany, whose export industry greatly profited from the introduction of the euro and as a consequence accumulated large surpluses. For less competitive economies,[3] such as

[1] (Kanter and Kitsantonis 2016).
[2] (Eurostat 2015) and (Eurostat 2015).
[3] To be more precise, country's competitiveness is usually measured in unit labor costs. The problem with Greece, was that, after adopting the Euro in 2001 until the outbreak of the financial crisis, its unit labor costs rose much faster than compared to Germany's unit labor costs, which lead to a significant loss in competiveness of the Greek economy (see (ECB 2012) and (Cesifo 2013)).

the Greek, operating under a common currency implies that the country must either run a trade deficit if it wants to maintain an equal level of domestic consumption or devalue its currency to restore the competitiveness of its economy, which, as a member of the European Union (EU), it could not do. A trade deficit essentially indicates that the country has to borrow from abroad or attract foreign investment. In the case of Greece, the former scenario was predominant. For instance, with the support of the European Commission and the European Central Bank (ECB), Greece was able to finance a wide variety of infrastructure projects, including the 2004 Summer Olympic Games in Athens. The fact that Greece belongs to the EU is crucial in explaining why Greece was able to accumulate such high levels of fiscal debt. As a member of the EU, the country could finance its fiscal deficit at interest rates considerably more favourable than the rates it received before joining the EU. These favourable rates led to the accumulation of sizable fiscal imbalances between 2004 and 2009. Another factor that allowed Greece to raise capital at too-favourable terms was the Greek government's practice of consistently underreporting its fiscal debt level over several years. Unaware of the true extent of the deficit, banks, hedge funds and even governments around the globe gambled on declining interest rates for Greek government bonds. Indeed, this strategy seemed to be very profitable. Between 1998 and late 2007, when the financial crisis broke out, interest rates for Greece's long-term debt had essentially converged to the rates paid by nations such as Germany and France. For instance, in the late 1990s the average spread between Greek and German sovereign bonds was little more than 3%, whereas in early 2005 this rates dropped to a mere 0.13%.[4] In other words, Greece could finance its public spending at the same borrowing costs as Germany, which had consistently reported more sound fiscal statements.

The economic rationale behind the fall in Greek government bond interest rates is that investors saw Greece as being a higher credit risk alone than as a member state of the EU for several reasons. First, by entering the union, Greece had to fulfil a number of economic criteria given in the Maastricht Treaty as well as the Stability and Growth Pact to increase its economic competitiveness and the creditworthiness of the government. Second, investors thought that Greece's membership in the EU would bring about an implicit bailout guarantee for Greek sovereign debt, which would be backed by other member states of the EU.[5] In other words, the common belief was that the EU would act as a security net and provide debt insurance to Greece in the event of problems. This view about the EU and in particular about Germany, which repeatedly emphasized its long-term political commitment to the European integration project, led to a complete underpricing of Greek sovereign debt risk.[6] Capital markets stopped evaluating Greek government bonds on the basis of expected fundamentals and started assuming that Germany, as the EU's most potent economic power, would step in if the Greek government failed to honour its financial

[4] (OECD 2016).
[5] (Nelson, Belkin and Mix 2011).
[6] (Arghyrou and Tsoukalas 2010).

obligations. This misapprehension and consequent mispricing ensured that numerous financial institutions were now exposed to Greek default risk, which, as it turned out, significantly impeded the restructuring of Greece's debt.

It is clear today, however, that the common belief of investors and banks around the globe turned out to be severely flawed. The convergence of yields occurred despite the nonexistence of a fiscal union or any form of government bailout guarantee that would back the issuance of sovereign debt of a European member country. Thus, in the event of sovereign solvency problems, there is no legal backbone to demand support for a troubled economy from other member states. In late 2008, when the financial crisis completely unfolded and capital for lending essentially dried up, Greece was unable to roll over its ongoing fiscal deficit by issuing new government bonds to cover outstanding debt.

Because financial markets were relying on Germany to help out Greece, it came as a big surprise that Germany had no intention to immediately support Greece, a development that significantly rattled investors' confidence. Moreover, when Germany announced that it would only provide aid conditional on certain structural reforms being implemented by the Greek government, the value of Greek government bonds crashed, which in turn made it almost impossible for Greece to issue new bonds in capital markets.[7] As a direct consequence of this loss of creditworthiness of the county's sovereign debt, Greece's borrowing costs spiked and worsened the already critical financial situation further. As the country's debt problem became unbearable, open speculation of an actual Greek default started to spread.

The conventional course to deal with a country that faces such insurmountable debt overhang involves a mix of two policies: devaluation of the country's currency and structured default on its debt. Clearly, the first policy is not an option for Greece unless the country exits the EU. Concerning the implementation of the second option, there are two possible routes: to bail out Greece by lending rescue funds or to have Greece default on its debt and then rescue the banks holding Greek bonds to ensure that the financial system keeps functioning. The European members opted for the former for several reasons. For example, implementing the second policy would have worsened the situation because several European banks from Germany, the United Kingdom, France and Italy had accumulated significant holdings in Greek government bonds during the pre-crisis period.[8] If Greece had defaulted on its debt, those banks would have suffered substantial losses, which would have resulted in the French, German and English governments having to bail out their domestic banking industries with taxpayers' money. Politicians in the lending economies desperately wanted to avoid this scenario. Even more problematic was the threat of debt contagion among other European economies, such as Portugal, Ireland, Spain and Italy, which were facing similar financial difficulties.[9] A Greek default could set

[7] (Osler 2015).
[8] (The New York Times 2015).
[9] (PIIE 2014).

off a chain reaction of bankruptcy within the financial sector that could then propagate a Europe-wide sovereign debt crisis with incalculable severity.

Therefore, by lending urgently needed funds to the Greek government, creditor countries also prevented their own banks and other weak economies from being dragged into a vicious credit crunch cycle. The lending countries banks indeed received their money. A recent study by the European School of Management and Technology (ESMT) concludes that less than 5% of the rescue package of more than 215 billion Euros actually was transferred to the Greek government and benefited private households.[10] The overwhelming majority of the granted credit was used to bail out European banks and governments that were heavily invested in Greek government bonds.[11] Specifically, 86.9 billion euros were used to serve previously issued debt; a staggering 52.3 billion euros were needed just to pay interest on the issued sovereign bonds, and 37.7 billion were transferred to recapitalize Greek banks. The tragedy is that the rescue of Greek banks turned out to be a catastrophic investment because they lost nearly 98% of their market value.

In the end, the International Monetary Fund (IMF) and the EU granted several bailout loans under the condition that structural reforms and strict austerity measures had to be implemented immediately. These measures were a set of economic policies aimed to reduce government budget deficits by increasing tax revenues and cutting public expenditures.

At this point, it is important to ask whether it is a good idea to cut spending in a depressed economy. In the short run, from a Keynesian point of view, the answer is certainly no. The Keynesian school of thought argues that in economic downturns, the government should increase spending, funded through deficits, in order to boost aggregate demand and therefore employment in order to pull the economy out of its slump. This point of view is also supported by economists at the IMF, who argue that attempts to reduce high levels of debt via austerity are self-defeating.[12] In fact, the opposite approach—that is, not increasing taxes or reducing government spending—is more effective when an economy is in the doldrums.[13] For instance, the government could carry out an expansionary fiscal policy by increasing investment in infrastructure projects and whereas the central bank simultaneously cuts interest rates. The Greek government could not pursue either policy. It lacked the funds required to invest in infrastructure, and borrowing in capital markets was no longer feasible given the large sovereign debt it had accumulated. Furthermore, interest rates were no longer under the control of Greek authorities because the country's monetary policy was steered by the ECB. Greece nevertheless has to regard itself as fortunate in obtaining a rescue loan in the first place; the IMF had to create a special exception to become involved in the Greek crisis because most conventional

[10] (Rocholl and Stahmer 2016) and (Ewing and Aldermanjuly 2015).
[11] (Sbaihi 2015).
[12] (Krugman 2015).
[13] (Blinder 2014).

approaches towards estimating the capacity of the Greek government to repay its debt were unsustainable.

Despite the critical financial situation Greece faced, European politicians supported the demanded austerity measures, which required a substantial decline in domestic spending and therefore accelerated the economic downturn. Unfortunately, implementing austerity measures in countries that do not have their own currency is highly problematic. Because Greece is in a monetary union, the country cannot simply devalue its currency to make its economy more competitive. The only path back to economic growth requires an arduous fiscal consolidation and a painful internal devaluation process, which is equivalent to an outright decline in wages and prices in order to restore competitiveness.[14] In the short term, such a process most likely will worsen the already dire economic crisis in Greece by increasing their debt-to-gross domestic product (GDP) ratio. On the one hand, tax revenues decline because of decreased economic growth and therefore make it more difficult to fulfil outstanding debt obligations. On the other hand, because debt is denominated in nominal euros, its level remains unchanged while GDP declines, leading to a rise in debt-to-GDP ratio that will make it even more difficult for Greece to borrow on the regular capital market. This is precisely what happened to Greece, whose debt-to-GDP ratio has been climbing since they started attempting to implement the austerity measures. [15] At its current debt-to-GDP ratio, Greece cannot access the private capital markets at affordable prices because the country would need to pay very high interest high rates. These rates mean that the only lenders Greece can turn to are either monetary institutions, such as the ECB or IMF, or the EU itself. The country's process to access necessary funds to pay off lenders, however, has been further complicated by the ECB's temporary decision to exclude Greek government bonds from its quantitative easing program because Greek bonds have reached junk status.[16] Despite the country's inability to access funds, EU politicians have not allowed Greece to default on its debt because their banks are heavily invested in Greece.

Internal devaluation is a long and painful route to reduce debt overhang and certainly is not the most efficient path back to economic growth. For instance, as economist Thomas Picketty points out, it took the British Empire over 100 years of strict budgetary discipline to repay its debt from the 19th century wars with Napoleon. He reckons that the British gave up two to three percent of their economic output to repay their debt, which was more than they spent on schools and education. [17] Numerous economists, therefore, have argued that instead of lending money to an essentially bankrupt country, a structured default represents another option that several states, including Greece, have taken previously.[18] Paradoxically,

[14] (Malliaropulos 2010).
[15] (Eurostat 2015).
[16] (Grauwe 2016).
[17] (Piketty 2015).
[18] (Kashyap 2015).

Germany, Greece's biggest lender and a strict advocate for austerity measures, opposed this solution even though it found itself in a similar situation after the Second World War, a period when Germany faced unsurmountable debt levels. Under the Marshall Plan to rebuild Europe and the London Debt Agreement of 1953, Germany received relief for 50% of its debt, which laid the foundation for Germany's rapid post-war recovery. In other words, without the forgiveness, farsightedness and, most importantly, the lessons learned from the Allies' mistakes after World War I, Germany would have never experienced the economic rejuvenation that brought the country unprecedented prosperity. In the case of Greece, European policy makers opted for quasi-debt relief via preferential interest rates and maturity extensions instead of actual nominal debt relief through default, a strategy that leaves Greece struggling under its debt burden for many years to come.

Not surprisingly, only a year after the IMF, ECB and EU granted their first bailout loan in 2010, Greece had to look for further rescue money. The Greek financial odyssey continued through 2012 and 2013 as Greece's Parliament approved unpopular austerity measures to honour the terms set for the ongoing EU-IMF bailout. The terms demanded layoffs of some 25,000 public servants as well as wage and budget cuts and tax reforms that pushed the country once again into social and political chaos.

Despite all the negative news in 2013, there were some signs in 2014 that the economic situation was ameliorating slowly. Indeed, as the IMF reported in its debt sustainability analysis, the Greek debt outlook was improving. The IMF also concluded that no further help was needed for debt relief and predicted that Greek debt would fall to 117% of GDP in 2020 and to 104% in 2022.[19] Unfortunately, the tide of political and economic calm turned once again when, only few months later in January 2015, the radical left-wing anti-austerity coalition, better known as the Syriza party, won a thundering victory in snap elections. The incoming Prime Minister was bad news for creditors because he intended to push for a renegotiation of bailout terms, debt cancellation and renewed public sector spending, which resurrected fears of Greek default and potential exit from the EU. Those fears were not groundless. Only six months into Tsipras' term, the Greek government failed to pay 1.6 billion euro to the IMF, making Greece the first developed country ever to default to the Fund. This default happened because negotiations between Syriza leadership and Greek creditors failed to come to terms just days before the IMF payments were due. At that point, Prime Minister Tsipras called for a referendum to oppose the EU proposal, which demanded fundamental reforms in return for urgently needed loans. One month later, however, Prime Minister Tsipras had to accept the terms of European creditors even though the Greek citizens overwhelmingly rejected the demanded bailout terms in a highly controversial referendum on July 5, 2015.

The antagonistic tactics of the Syriza-led government poisoned the promising economic recovery, which evaporated in 2015. Amidst fear of yet another election and

[19] (IMF 2015) and (The Economist 2015).

newly imposed capital controls to mitigate the drain of deposits, economic and political uncertainty blighted any progress.

Recent academic work explores the impacts of high political uncertainty on economic growth. What researchers have found is that increases in fiscal policy uncertainty, such as heightened doubt about whether taxes or subsidies are going to be changed, reduces investments by firms and increases unemployment.[20] Furthermore, research has shown that firms reduce investment prior to elections and that sudden changes in uncertainty about future fiscal policy have adverse effects on economic activity and therefore on tax revenues.[21] The IMF group, under the leadership of Mr. Blanchard, put forward this argument, which certainly applies to the tumultuous political situation in Greece because the country has had to push through no less than 11 austerity packages to date and has sworn in seven prime ministers since 2009. In addition, Greece froze or cut salaries and bonuses of government employees a number of times, drastically reformed pension plans, imposed restrictive capital controls and raised various tax rates. These changes occurred only months apart from each other. Moreover, the efficient implementation of the numerous austerity packages demanded the immediate formation of a political majority, which was an especially challenging task given the tremendous political uncertainty Greece faced.

In light of this argument, it is important to ask whether a recession could have been avoided if the rescue packages were designed correctly. The answer to this question is almost surely not. As the IMF points out, Greece lost access to capital markets in the first half of 2010 with a fiscal deficit so large and amortization obligations so onerous that it is difficult to see how a severe economic contraction could have been avoided.[22] Without the ability to borrow, Greece would have to finance its expenditures solely through tax revenues, which would have required primary fiscal balance. To achieve that balance would have necessitated a drastic consolidation of public expenditures, an unlikely scenario given that tax income was falling. As the IMF concluded, therefore, a deep recession was unavoidable in any case.[23] However, it remains disputed whether a rescue package with more facile austerity measures would have lessened the severity of the economic downturn.

Moreover, the implementation of strict capital controls is a highly disputed policy measure.[24] On the one hand side, the aim of imposing such controls is to stop capital from fleeing the country. In essence, when people start withdrawing their money, banks face a liquidity problem as most of people's money has been used to give out loans and credit to firms and other households. In the case of Greece, this outflow of deposits has forced the ECB to step in numerous times and provide liquidity in order to stabilize the Greek banking system. Therefore, without capital controls, there would very likely be a severe bank run, followed by a subsequent

[20] See for instance (Julio and Yook 2012) and (Baker, Bloom and Davis 2012).
[21] (Fernandez-Villaverde, Guerron-Quintana, Kuester, Rubio-Ramirez 2012).
[22] (IMF 2013).
[23] (IMF 2013).
[24] For a discussion on the theoretical and empirical literature on capital controls see (Engel 2011).

flight of capital abroad and a domestic credit crunch as banks would no longer be able to lend. In the case of Greece, which saw its citizens withdrawing more than 100 billion euros, such a government policy to halt the drain of capital seems very reasonable.[25]

However, the imposition of capital controls has a very disruptive impact on the business cycle. Especially for importing firms, capital controls essentially make it impossible for them to pay for goods and services.[26] Furthermore, almost mechanically, consumer spending is declining as Greek citizens predominantly have been using cash to pay for goods and services.[27] And now the damage caused by capital controls becomes more visible with every additional day they are in place. The tourist industry, one of the key pillars of the Greek economy, is beginning to suffer as foreign reservations have dropped significantly. Even more dramatic, hospitals run out of medications and even food shortages are a looming threat as Greece imports nearly half of its food.[28]

In light of the previous discussion, the imposition of capital controls is definitely no free lunch. Moreover, in the Eurozone, capital controls should never really be needed as, in theory, all banks of a EU member country, can access the Emergency Liquidity Assistance (ELA) program of the ECB. Thus, even if Greek citizens continue to withdraw their money, Greek banks could obtain liquidity through the ELA program and therefore avert a funding crunch of the banking system.[29] However, the eligibility for accessing credit through the ELA program hinges on two criteria's: First, such an emergency loan can only be granted against sufficient collateral. In the case of Greek banks, which have predominantly used government-linked assets, it became increasingly more difficult to provide sufficient collateral.[30] Thus, the fact that the Greek government was still struggling to meet its financial obligations had a direct implication on the borrowing capacity of Greek banks. Secondly, because of the continuing drain of deposits, which even accelerated after the Syriza party took over power in January 2015, Greek banks had to substantively make use of the ELA program and hit the maximum borrowing level the ECB allows several times. Therefore, because of the dire financial situation both the Greek government and their banks were facing, capital controls were the last resort in order to prevent a complete meltdown of the Greek banking system. However, these controls should only be used as short term instruments in order to relieve a distressed economic situation, because their long run impact on the economy is severely negative.

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[25] (Rogoff 2015).
[26] (Bossart 2015).
[27] Even though there are several negative effects of capital controls, they may help to tackle Greece's significant black market problem. Since electronic payments are much easier to track, tax evasion has become more difficult since capital controls were imposed.
[28] (Economist 2015).
[29] Details about the ELA program can be found at (ECB 2014).
[30] (ECB 2015).

Another extensively discussed suggestion is a potential exit of Greece from the EU, also referred to as 'Grexit' in the media. In the short run, this scenario would increase economic uncertainty and possibly lead to substantial outflows of deposits along with a potential banking crisis, and very likely again, the government would need to impose capital controls to avoid bank runs. Furthermore, the country would have to introduce a new currency or perhaps return to the drachma, and a poorly managed transition would cause further troubles and make borrowing capital even more difficult for the Greek government. Also, in view of Greece's dire economic situation, investors would lack confidence in the drachma. As a direct consequence, the new currency would very weak currency and would most likely depreciate against the euro over time. Given that Greece's debt is denominated in euros, a switch to the drachma would leave the Greek government with substantial exchange rate risk that could make debt repayment essentially impossible if the drachma depreciates. This scenario could lead to an even faster Greek default.[31]

In the long run, however, there are clear economic benefits for reintroducing the drachma. A weak currency makes domestically produced goods more competitive in international markets and boosts tourism, which would help increase Greek exports markedly and improve the country's trade balance. Furthermore, because exports account for roughly 30% of GDP, higher growth rates would raise tax revenue and therefore help to close the fiscal budget deficit.[32] This strategy, however, would only be successful if the country can effectively collect the owed taxes. A notorious problem in Greece is that expected government tax revenues persistently fall below actual tax revenues. The differences between the numbers are substantial. For example, in 2010, estimated tax evasion costs amounted to more than 20 billion euros or approximately 10% of Greece's GDP that year.[33] Furthermore, a large number of payments are delayed for months or even years.

Another benefit of having a weak currency is an increase in consumption of domestic goods as imported goods become more expensive, which would promote the creation of new jobs in Greece. Finally, an independent monetary and fiscal authority could set policies that are more in line with the needs of the Greek economy. This scenario, however, is not very popular among European politicians, who fear that their vision of a united Europe would tumble down if member states start leaving the union. This is indeed a very pressing concern in light of Britain's recent decision to leave the European Union, which unleashed a shockwave across Europe and may jeopardize the future of the EU. It may not be long before discussions of a potential Grexit are back on the negotiation table in Brussels.

The continuous debate about how to deal with the Greek debt crisis reveals the whole complexity of the problem. In retrospect, one could conclude that even though the foreign-imposed austerity measures were appropriate in principle because they

[31] To facilitate the transition to a new currency, Greece' currently outstanding debt could be converted from Euros to drachmas. This of course would imply that now the lenders would bear all the exchange rate risk.
[32] (World Bank 2016).
[33] (Die Presse 2009).

forced Greece to balance its fiscal budget and implement urgent, fundamental reforms to promote economic growth, these measures were pushed through too soon. The damage caused to the political and economic conditions of the country by hasty implementation far outweighed the relief of debt burden provided by the financial aid packages. Thus, the sudden slashing of spending and the misguided increase of taxation spurred economic and political uncertainty that has severely hampered both fiscal and private investment that are critical to restore competitiveness of Greek firms and to promote economic growth.[34] Moreover, the sharp increase in consumption taxes actually did not lead to higher sales tax revenue because the decline in people's consumption as a result of these higher rates was so substantial that it outmatched the hoped-for sales tax revenues, thereby worsening the fiscal budget instead of improving it.[35]

Looking back, even the IMF, under the leadership of Dominique Strauss Kahn, had to revise its projection that nominal GDP would rise by 13% between 2009 and 2015.[36] In fact, by July 2013 it was abundantly clear that those growth projections were overoptimistic and had to be revised sharply downward. New projections released in 2013 expected nominal GDP to decline by 18% over the same time period. This drastic adjustment in growth predictions shows that even economic experts significantly underestimated the fiscal multiplier on government expenditure during a recession. In other words, the fiscal multiplier was substantially higher than the experts had anticipated, and the enormous decline in Greek government expenditure resulted in an enormous contraction in GDP.[37]

On the other hand, it is hard to imagine that Greece would have experienced fewer problems had it simply defaulted on its debt in early 2010. Because of the interconnectedness of the European economies and the involvement of several banks that held significant amounts of Greek sovereign debt, an uncontrolled default could have caused debt contagion across Europe, which could have bankrupted other European countries, such as Portugal, Ireland and Spain. Thus, a default could have brought the entire European economy to the brink of collapse. Given that several EU member states already faced financial difficulties, policy makers, including the ECB, correctly intervened in the credit market by offering rescue packages and simultaneously loosening monetary policy to boost market confidence and spur growth.

Finally, the exclusion of Greece from the EU could have long-term economic benefits for Greece because the country's competitiveness would eventually improve as a result of a new, weak currency. Such a scenario, however, contrasts starkly with the political ideology of a united Eurozone. Indeed, several members of the European Parliament and political leaders of Germany and France emphasized their

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[34] To give another example of the extremity of the changes in tax policies, in October 2013, the Greek government increased tax rates on heating oil by 450%, forcing people to cut and burn wood for heat, which caused severe air pollution (The New York Times 2015).

[35] (The New York Times 2015).

[36] (IMF 2013).

[37] A fiscal multiplier quantifies the amount by which aggregate output (GDP) changes due to a change in government spending.

commitment to defend the Eurozone; likewise, Mario Draghi, the current head of the ECB, vowed, 'We do whatever it takes to defend the Euro'.[38] This shows that the Greek debt crisis is not merely a financial matter but also a deeply political and ideological one.

Now, in Summer 2016, Greece once again stands at the verge of collapse, and Prime Minister Alexis Tsipras is asking European leaders for looser terms on sorely needed aid to help his country avoid bankruptcy. One can only wonder whether it will be the last time or will the debt burden continue hanging like the Sword of Damocles over the country's future?

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[38] (Draghi 2012).

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