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Time for Catharsis: More Reform in Greece in Return for Debt Reduction

Patryk Toporowski

Greece is still stuck in a deep economic crisis, and the chances of a fast recovery are slim. The blame for this lies with both the Greek government, for retarding the pace of reforms, and the "Troika," for focusing too heavily on austerity measures. The optimal solution is to focus on strengthening the institutions of Greece and make supply-side reforms in exchange for the promise of debt relief.

Syriza, the party contesting the validity of the two aid schemes agreed between the Greek government and the Troika (the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF)), is leading in the pre-election polls. Victory for Syriza would mean that Greece would depart from the current course of difficult reforms and, as the coalition government warns, exit from the eurozone and go bankrupt. A good result for the party should be no surprise, for the Greek economy is still in deep crisis.

There are many signs of weakness. GDP dropped every year since the beginning of the crisis, but it is expected that 2014 will show that it stabilised and grew.. The growth forecasts for 2015 are uncertain. In addition, companies are still fleeing, with Bulgaria a popular destination in 2014. The bad situation and investment climate translate into high unemployment, and the forecast of 25% for 2015 is only slightly better than in 2014.

The important goal of reform, to reduce public debt, was only partially achieved. Although the deficit fell between 2008 and 2014 to below 3% of GDP, and structural budget balance was above 3% of GDP in 2013, the state debt increased from around 99% to about 175% of GDP. Bad debt is also a heavy burden for the banking sector, as debtors in 2014 did not pay around 33% of all matured loans.

There are also some signs of improvement. The competitiveness of the economy is slowly increasing (the current account balance is improving, and in 2015 it will go into the black), unit labour costs have fallen (by an estimated 10% from 2010 to 2015), and, in 2014, Greece returned to the financial markets. However, these signals still give little hope for a way out of the crisis and the social costs of austerity policies. It should not be surprising, then, that in this situation public opinion in the EU seeks a scapegoat. Some, for example the Troika and the German government, as well as experts and the public, indicate Greece's reluctance to implement reforms. Others, among them Syriza, but also the governments of Italy and Portugal, say that the aid packages were inadequately prepared and therefore harmful.

Greece's Pledge. Athens has so far obtained two financial assistance rescue programmes, revised repeatedly and prepared by the Troika. The overall objective of the first programme was to reduce the deficit to 3% (mostly by, for example, cutting staff and wages in the public sector, cutting pension payments, health sector cuts, and increased taxes), to start to reduce debt in 2014, and to balance the current account. Structural reforms, including lowering the cost of local government and making it easier to establish companies, were another important element of the package. The stability of the financial sector has also been an important issue within the commitments of the Greek government.

The second assistance programme was created when it turned out that the means within the first were not sufficient to stabilise the country. Under this programme, the Troika also stressed as well the non-fiscal commitments, and in addition to the objective of stabilising public finances, improving competitiveness became an important target. Reduction in unit labour costs through a flexible labour market, and privatisation, have become priorities. Similarly, as

in the first bailout, the Troika stressed the need to improve public administration, so as to guarantee that the reforms could be effectively carried out.

Intractable Greece. Although the government made many reforms, it failed to comply with all the obligations arising from the rescue packages. The German government, public opinion and experts state that the Greek authorities repeatedly softened and delayed reforms, in contrast to Ireland and Portugal, which immediately brought provisions of the financial assistance programmes into force. Because of delays, many commitments are still in progress, although they could have been finished. Olli Rehn, the then commissioner for economic and monetary affairs, expressed in mid-2014 the opinion that the pace of reforms in Greece had slowed down markedly.

The three most important areas which saw the greatest delays were the motivation-oriented scheme of salaries in the state administration, the system that facilitates quick settlement of tax arrears, and the possibility to divide tax liabilities into 100 instalments. Other unresolved issues include the property law (the government halted this reform), the fight against corruption, and privatisation. The Troika believes that this is due to the influence of local oligarchs (who are interested in maintaining the status quo) on the government apparatus, as well as the influence of the domestic political cycle and the weakness of state institutions.

The Troika's Fault. Greece's negligence, however, is only one side of the coin. The other one is the Troika's inappropriate policy. The most serious argument against the shape of the aid packages is a critical self-assessment made by the IMF, one of the authors of these programmes, in mid-2013. The institution itself alleges that it underestimated the negative impact of restrictive fiscal policy on the economy. The IMF believed that the programme did not restore calm to the markets, it did not stop the loss of 30% of deposits in the banking sector, and it has contributed to a deeper than expected recession and increasing unemployment. In other words, the institution admits that, from its point of view, the structural reforms should have been more important than the consolidation of the public finances.

The Troika's activity was also attacked by MEPs, who primarily blamed the inaccurate prediction of the state of the Greek economy after the reforms. The report of the European Parliament in March 2014 reproached overly optimistic expectations of the macroeconomic situation in the bailout countries, as well as insufficient cooperation with the local administration on reforms. Insufficient attention paid to mitigate the negative side effects of reforms was a flaw in the assistance packages. The EP also pointed out the inconsistency between the goals of the IMF (internal devaluation, that is, the reduction of wages in the economy within the countries covered by the aid programmes) and the EC (stabilisation of public finances).

There is also another source of erroneous solutions made by the Troika. The prolonged and deeper than expected stagnation in the eurozone has had a negative impact on Greece's weaker economic performance, and therefore its financial stability. The Troika's forecasts did not take into account such a deep or prolonged crisis in the EU and, for this reason among others, projections about the state of the Greek economy were overly optimistic. In consequence, the effects of the assistance packages appeared to be unrealistically mild.

Relief as a Solution to the Impasse. In the debate on the current weakness of Greece, both critics of the government in Athens and the Troika are right. The delays in reforms are very risky for debt-ridden Greece. Apart from the threat of national insolvency, the most serious consequence is the reduction of the long-term competitiveness, which, bearing in mind the huge debt, will further lower the standard of living of the Greeks. A brake on changes in such areas as the quality of public administration (including resistance to corruption and the ability to create, implement and coordinate comprehensive plans) has the strongest effect on entrepreneurship in the SME sector and investment, and consequently on the unemployment rate.

From a different perspective, the Troika's excessive determination to maintain austerity in Greece has led to deepening recession and unemployment, and thus to increasingly higher, now enormous, economic and social costs. In addition, paradoxically, the debt can grow rather than fall, as was intended. The emergence of political instability and anti-systemic movements are at the end of this domino effect.

The only reasonable way out of this deadlock is to combine pro-growth reforms with granting debt relief to Greece. This could take the form of the extension of the loans' maturity, or of re-buying debt on favourable terms for Greece. But the most courageous and beneficial for solution for Greece (although unlikely due to Germany's resistance) would be retiring a portion of the debt. In this way, the new government would obtain confirmation that the EU supports reforms, while the economy has time to catch its breath. A reduced fiscal burden would translate into faster visible results of reforms, and it would weaken the negative sentiment in society on assistance programmes, thus increasing their legitimacy.

Poland did not contribute to the assistance programmes for Greece, and that is why debt relief would not have a direct impact on Polish public finances. However, the stability of the eurozone is in Polish interests, and crisis-driven Greece weakens it. To date, there is no certainty that such a high debt is possible to pay by any country, which means that it is only a matter of time before systemic risk appears in the eurozone. Therefore, reduction of the debt to a level that allows repayment is de facto in the interests of all Member States and prospective eurozone members. At the same time, as the reduction of debt will not solve the problem of low competitiveness of Greece, Poland should promote making relief or cuts in debt repayment conditional on a serious continuation of reforms, both institutional and supply-side.