

Greece: Past Critiques and the Path Forward



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All eyes are on Greece, as the parties involved continue to strive for a lasting deal, spurring vigorous debate and some sharp criticisms, including of the IMF.

In this context, I thought some reflections on the main critiques could help clarify some key points of contention as well as shine a light on a possible way forward.

The main critiques, as I see them, fall under the following four categories:

- The 2010 program only served to raise debt and demanded excessive fiscal adjustment.
- The financing to Greece was used to repay foreign banks.
- Growth-killing structural reforms, together with fiscal austerity, have led to an economic depression.
- Creditors have learned nothing and keep repeating the same mistakes.

Critique 1: The 2010 program only served to raise debt and demanded excessive fiscal adjustment.

- Even before the 2010 program, debt in Greece was 300 billion euros, or 130% of GDP. The deficit was 36 billion euros, or 15½ % of GDP. Debt was increasing at 12% a year, and this was clearly unsustainable.
- Had Greece been left on its own, it would have been simply unable to borrow. Given gross financing needs of 20–25 % of GDP, it would have had to cut its budget deficit by that amount. Even if it had fully defaulted on its debt, given a primary deficit of over 10% of GDP, it would have had to cut its budget deficit by 10% of GDP from one day to the next. These would have led to much

larger adjustments and a much higher social cost than under the programs, which allowed Greece to take over 5 years to achieve a primary balance.

- Even if existing debt had been entirely eliminated, the primary deficit, which was very large at the start of the program, would have had to be reduced. Fiscal austerity was not a choice, but a necessity. There simply wasn't an alternative to cutting spending and raising taxes. The deficit reduction was large because the initial deficit was large. "Less fiscal austerity," i.e., slower fiscal adjustment, would have required even more financing cum debt restructuring, and there was a political limit to what official creditors could ask their own citizens to contribute.

Critique 2: The financing given to Greece was used to repay foreign banks

- Debt restructuring was delayed by two years. There were reasons for it, namely concerns about contagion risk (Lehman was fresh in memory), and the lack of firewalls to deal with contagion. Whether these reasons were good enough can be argued one way or the other. In real time, the risks were perceived to be too high to proceed with restructuring.
- Partly as a result of this delay, an important fraction of the funds in the first program were used to pay short term creditors, and to replace private debt by official debt. The bail-out did not however only benefit foreign banks, but also Greek depositors and households, as one-third of the debt was held by Greek banks and other Greek financial institutions.
- Moreover, private creditors were not off the hook, and, in 2012, debt was substantially reduced: The 2012 private sector involvement (PSI) operation led to a haircut of more than 50% on about €200 billion of privately held debt, so leading to a decrease in debt of over €100 billion (to be concrete, a reduction of debt of 10,000 euros per Greek citizen).
- And the shift from private to official creditors came with much better terms, namely below market rates and long maturities. Look at it this way: Cash interest payments on Greek debt last year amounted to 6 billion euros (3.2% of GDP), compared to 12 billion euros in 2009. Or put yet another way, interest

payments by Greece were lower, as a proportion of GDP, than interest payments by Portugal, Ireland, or Italy.

Critique 3: Growth-killing structural reforms, together with fiscal austerity, have led to an economic depression

- Given the dismal productivity growth record of Greece before the program, a number of structural reforms were seen as necessary, ranging from a reform of the tax administration, to reduced barriers to entry in many professions, to reforms of pensions, to reforms of collective bargaining, to reforms of the judicial system, etc.
- Many of these reforms were either not implemented, or not implemented on a sufficient scale. Efforts to improve tax collection and the payment culture failed completely. There was fierce resistance to open closed sectors and professions. Only 5 of 12 planned IMF reviews under the current program were completed, and only one has been completed since mid-2013, because of the failure to implement reforms.
- The decrease in output was indeed much larger than had been forecast. Multipliers were larger than initially assumed. But fiscal consolidation explains only a fraction of the output decline. Output above potential to start, political crises, inconsistent policies, insufficient reforms, Grexit fears, low business confidence, weak banks, all contributed to the outcome.

Critique 4: Creditors have learned nothing and keep repeating the same mistakes

- The election of a government in 2015 openly opposed to the program further decreased ownership and required revisiting the existing program, both in terms of policies and in terms of financing.
- A more limited set of structural reforms, or/and a slower fiscal adjustment implies, arithmetically, larger financing needs, and, by implication, more need for debt relief. To take an extreme case, if the European creditors were willing to simply forget all existing debt and extend further financing, there would be little need for more adjustment. But, clearly, there were and are political limits

to what they can ask their own citizens to contribute.

- Thus, a realistic solution had to involve some adjustment, some financing, and some debt relief — a balanced approach. The role of the IMF in the negotiations was to ask for specific credible adjustments in policies, and make explicit the financing and debt relief implications.
- We believed that a small primary surplus, increasing over time, was absolutely necessary to maintain debt sustainability. Having examined the budget closely, we did not see how this could be achieved without VAT reform to broaden the tax base, and pension reform to put the pension system on a sustainable footing. On these, our views coincided fully with those of our European partners.
- Until the referendum and its potential implications for growth, we believed that, under these assumptions about the primary surplus, debt sustainability could be achieved through the rescheduling of existing debt, and long maturities for new debt. This was reflected in the preliminary debt sustainability analysis (DSA) we put out before the referendum. Our assessment was seen as too pessimistic by our European partners to whom we had communicated our views about the need for debt relief long before publishing the debt sustainability analysis. We believe that current developments may well imply the need for even more financing, not least in support of the banks, and for even more debt relief than in our DSA.

A Path Forward

1. Given the results of the referendum, and the mandate given to the Greek government, we believe that there may still be room for an agreement. It should be based on a set of policies close to those discussed before the referendum, amended to take into account that the government is now requesting a 3-year program, and a more explicit recognition of the need for more financing and more debt relief.
2. Fundamentally, the Euro area faces a political choice: lower reforms and fiscal targets for Greece means a higher cost for the creditor countries. The role of

the Fund in this context is not to recommend a particular decision, but to indicate the tradeoff between less fiscal adjustment and fewer structural reforms on the one hand, and the need for more financing and debt relief on the other.

3. The room for agreement is extremely narrow, and time is of the essence. There should be no doubt that exit from the Euro would be extremely costly for Greece and its creditors. The introduction of a new currency, and of redenomination of contracts, raises extremely complex legal and technical issues, and is likely to be associated with a further large decline in output. It may take a long time for the depreciation of the new currency to lead to a substantial turnaround.

In sum, we still believe there is a path forward. The Fund is committed to helping Greece through this period of economic turmoil. Given Greece's failure to make a repayment due to the IMF on June 30, the Fund would be unable to provide any financing until the arrears are cleared. However, we have offered to provide technical assistance, where requested, and we remain fully engaged.

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