Greek debt crisis: developments in 2015

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A four-month extension to the current Greek bailout programme was agreed on 20 February 2015 between the new Greek government and the other 18 Eurozone finance ministers. This followed weeks of at times acrimonious negotiations and eased short-term fears of Greece defaulting on its substantial debts, and possibly leaving the Eurozone.

Greece's economy has undergone a severe recession since the debt crisis began in 2010, with the economy over a quarter smaller now than it was then. Two international bailout programmes in 2010 and 2012 have provided a total of around €240 billion (£178 billion) in financial aid to Greece. Attached to these loans have been stringent conditions designed to reduce the budget deficit and improve economic competitiveness.

Against this backdrop of continued severe economic and social pain, the radical left-wing Syriza party, who promised to reject the austerity measures, won the January 2015 election beating the incumbent centre-right New Democracy party.

With the expiration of the current financial assistance programme approaching on 28 February 2015 and the solvency of Greek banks under threat, the Greek government appeared to back down from most of its demands in order to secure an extension until the end of June. A successful implementation of this deal will result in around €7 billion (€5.2 billion) in financial assistance to Greece. This will likely occur after the end of April when economic reforms put forward by Greece will need to be approved by its creditors (the other Eurozone member states, International Monetary Fund and the European Central Bank).

In the meantime, Greece still faces questions over whether it will have the means to make debt repayments that are due in March and April. A solution to this problem is considered likely but a longer-term agreement to secure Greece's future is far from certain. The question of whether Greece will stay or leave the Eurozone is far from settled.

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1 Background

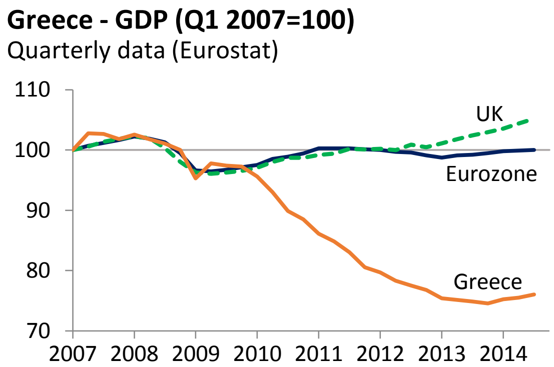
1.1 2010 and 2012 bailouts

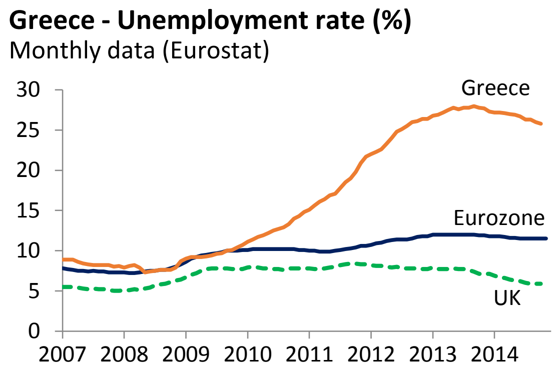
Greece's long-standing public debt problem became a crisis at the start of 2010. In the face of rising government borrowing costs, the country first requested international assistance in April 2010. The €110 billion (£81 billion[1]) Eurozone-International Monetary Fund (IMF) loans agreement it received came with strict conditions on economic policy and reform designed to make the Greek economy more competitive. A worsening recession and rising public opposition to further austerity meant the Greek government struggled to meet the conditions of the agreement. Meanwhile, the prospects of it returning to borrow on the open market by 2012, as originally envisaged, became increasingly hopeless.

A second package of financial assistance was agreed with the Eurozone and IMF in February/March 2012 and was a more complicated arrangement than the first. As well as the traditional 'loans and austerity', the second bail-out involved Greece's private sector creditors taking losses – totalling around €100 billion (£74 billion) – on their holdings of Greek sovereign debt: this followed from a belated recognition that no amount of austerity and loans on their own could put Greece's debt burden at the time on a sustainable footing.[2] The second bailout brought the total combined financial assistance to around €240 billion (£178 billion).[3]

1.2 Economic situation

The economy entered into recession in 2008 and saw persistent contractions in economic activity until 2014, when growth finally returned. Overall, real GDP has fallen by over 25% since the depression began.[4] During the Great Depression, the US economy shrank by a similar magnitude: 26% between 1929 and 1933.[5] (By way of comparison, the UK's economy shrank by 6% during the 2008/2009 recession.)





The fall in output has led to a steep fall in living standards and social conditions. The unemployment rate increased from around 8% in 2008 to 28% in mid-2013, before falling back slightly to 26% by the end of 2014. The youth unemployment rate rose to nearly 60% in 2013 and was still at 50% in late 2014.[6] The number of people in work fell by around one million – a 20% decline in the employed population. Wages have declined, poverty has

[1] All currency conversions in this note are based on the exchange rate of €1.35 per £1 as of 23 Feb 2015.
[2] For more on this "private sector involvement" see Reserve Bank of Australia Statement on Monetary Policy, "The Greek Private Sector Debt Swap", May 2012
[3] For more on the bailouts see the Library Note *The eurozone crisis – rescuing Greece,* May 2012
[4] Hellenic Statistics Authority (Elstat), table 6 – quarterly GDP
[5] US Bureau of Economic Analysis, National Income and Product Accounts Tables, table 1.1.3 real GDP
[6] Eurostat, Unemployment rate by age

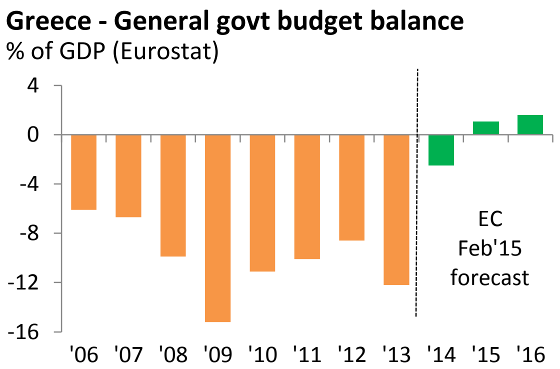
increased and deprivation has risen.[7] It's no surprise then that many people in Greece are unhappy – three-fifths of people say they are not satisfied with the life they lead (the EU average is one-fifth) and three-quarters say that the financial situation of their household is bad (the EU average is just over one-third).[8]

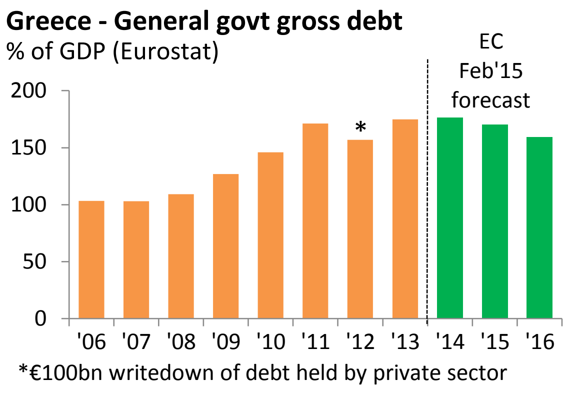
1.3 January 2015 Greek elections and Syriza's platform

Against this backdrop of years of economic depression, high unemployment and austerity, the radical left-wing Syriza party won the 22 January 2015 general election beating the incumbent centre-right New Democracy party. Syriza fell two seats short of an overall majority in parliament and thus formed a coalition with the right-wing Independent Greeks who share their anti-austerity views. Syriza's leader, Alexis Tsipras, became Prime Minster.[9]

Syriza campaigned against the conditions attached to the bailout agreements and pledged to reverse many of the austerity measures introduced in recent years, such as the 22% reduction in the minimum wage. It believes, along with a number of economists,[10] that the cutting of public spending and tax increases introduced in order to attempt to reduce Greece's large budget deficit had been counterproductive. It argues that this led the economy into a vicious negative spiral of weaker demand causing weaker public finances, in turn resulting in the imposition of even tougher austerity conditions. Syriza pledged to stop dealing with the 'Troika' of the European Commission, the European Central Bank (ECB) and the IMF, who have overseen the bailout funds and imposed the conditions associated with them (known as the Memorandum of Understanding).

Syriza said its vow to renegotiate the terms of the bailout agreement would also include a request for debt relief. Greece's stock of debt is the second highest in the world at over 175% of its GDP,[11] or €315 billion (£233 billion), the majority of which is owed to the Eurozone bailout funds and therefore ultimately to the other Eurozone countries.[12] Syriza is committed to keeping Greece in the Eurozone.





[7] European Commission, *2014 Employment and Social Developments in Europe Review*, 15 Jan 2015, p269/308

[8] European Commission, *Eurobarometer 81*, carried out November 2014. Figures on satisfaction based on the question "On the whole are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the life you lead?" – 41% of people in Greece were very satisfied or fairly satisfied, compared with 79% across the whole European Union. Figures on financial situation are based on the question "How would you judge the current situation in each of the following? The financial situation of your household" – 25% of people in Greece said it was good or very good, compared with 65% across the European Union.

[9] For more on the election see Library note SN7076, *Greece's new anti-austerity coalition*, 28 Jan 2015

[10] For example Simon Wren-Lewis, Martin Wolf or Paul Krugman; not all economists agree with this view

[11] IMF estimates of gross debt for 2014. Japan has the highest debt ratio at 245% of GDP.

[12] "Greece Seeks Third Debt Restructuring: Who's on the Hook?", Bloomberg, 2 Feb 2015

2 Greek banks reliant on funding from the ECB

Greek bank balance sheets are plagued with very high levels of non-performing loans (where the borrower is not making repayments to the bank); the IMF estimated in June 2014 that 40% of all loans provided by Greek banks at the end of 2013 were non-performing.[13] Greek banks also hold a large quantity of Greek government bonds.

Shut out of the interbank lending markets, Greek banks are heavily dependent on funding from the European Central Bank. Although the ECB on 4 February stopped accepting Greek bonds as collateral for funding, it still provides a final lifeline to Greek banks through its Emergency Liquidity Assistance (ELA) programme.[14] This channels a fixed amount of funds to the Greek central bank which is then available to Greek Banks. ELA funding is intended to be temporary and for solvent banks only.[15]

The ECB raised the cap on ELA funding available to Greece by €3.3 billion to €68.3 billion on 18 February, less than that requested by the Greek central bank according to reports.[16] Changes to ELA funding need to be approved by two-thirds of the ECB Governing Council.[17]

Increases in ELA funding are crucial for Greek banks in order for them to replace an outflow of deposits. Bloomberg reported that €20 billion in deposits left the country from December to mid-February, likely due to the uncertainty about the election and the subsequent negotiations surrounding the future of the bailout.[18] Should ELA funding not prove sufficient, Greece would likely need to impose capital controls to stop deposits leaving the country.

Given Greek banks' large holdings of its government's debt, their solvency is closely linked to that of the state. A failure to either extend or replace the current bailout programme would probably result in Greece defaulting on its debt (as it would not have the funds to service it). If this were to happen the ECB would most likely reduce or end ELA and Greek banks would probably become insolvent. As a result, the ECB is keeping a close eye on negotiations surrounding the future of the bailout programme.

3 Early 2015 negotiations on extending financial assistance

3.1 Funding from the bailout agreement

Under the current package of assistance, the release of each disbursement to Greece must be approved by both the Eurogroup (of Eurozone finance ministers) and the IMF's Executive Board. Prior to this decision, the European Commission, the ECB and the IMF staff conduct joint review missions to Greece in order to monitor compliance with the terms and conditions of the programme.[19] A review is currently underway.

The existing agreement between Greece and the Eurozone bailout fund, the European Financial Stability Facility (EFSF), was due to expire on 28 February 2015.[20] The final tranche

[13] IMF staff report, "Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access", Jun 2014, p7

[14] ECB press release, "Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations", 4 Feb 2015

[15] "Bank funding powers make Greece vulnerable to ECB pressure", Reuters, 15 Feb 2015

[16] "ECB tightens pressure on Greece with cap on bank funding", Reuters, 18 Feb 2015

[17] The main decision-making body of the ECB comprised of six Executive Board members and the heads of the 19 national central banks; at any one time 21 members having voting rights – the six Executive Board members and 15 out of the 19 national central bank governors (these are rotated)

[18] "Greeks Backing Tsipras With Votes But Not Cash", Bloomberg, 19 Feb 2015

[19] European Commission, *Financial assistance to Greece* [online, accessed 5 January 2015]

[20] The agreement between Greece and the IMF runs until 2016.

of loans worth €1.8 billion (£1.3 billion) from this fund will only be provided after the latest review is concluded successfully. An associated €1.7 billion (£1.3 billion) held by the ECB,[21] and a further €3.5 billion (£2.6 billion) from the IMF[22] will also be available after this review is completed, providing a potential total of €7 billion (£5.2 billion) in funding to Greece.

3.2 Difficult negotiations on proposed extension of bailout

With this 28 February deadline looming, the new Greek government and its Eurozone counterparts began discussions how to proceed. The main forum for negotiations has been the Eurogroup – a meeting of the finance ministers of the 19 Eurozone member countries. Meetings on 11 February and 16 February ended without agreement. A further Eurogroup was scheduled for Friday 20 February. Between these meetings, technical discussions were held and draft statements were floated. Of course, significant differences between the Greek government and the rest of the Eurogroup, particularly the German government who took a firm line, had to be bridged. Growing distrust between the two sides added to the difficulty.[23]

Over the course of these negotiations, the Greek government proposed that the existing financial assistance programme be extended for six months – from end-February to-end August – and would accept the European Commission, the ECB and the IMF (renamed "institutions" rather than "the troika") to continue oversight of the terms of the programme. It also promised to pay its debts in full. In return it wanted some flexibility over some of the specific economic reforms contained in the agreement and for it to be allowed to run a smaller primary budget surplus – this is the budget balance excluding debt interest payments. These proposals were submitted to the Eurogroup one day ahead of the Friday 20 February meeting.[24]

A number of observers felt that this proposal went a long way towards a final agreement, not least because the Greek government had appeared to climb down on a number of its original demands. However, the German government rejected the proposal, with a finance ministry spokesmen stating that it "aims at bridge financing without fulfilling the demands of the programme."[25] Instead they called for Greece to complete the previously-agreed programme, including all the conditions attached to it.

3.3 Provisional agreement of 20 February

On Friday 20 February, the Eurogroup came to a deal that would extend the financial assistance programme to Greece for four months, up until the end of June.[26] The terms of this agreement are summarised below.

Extension of current programme

The current bailout programme will continue, with its deadline extended from 28 February to end-June, in order for the "institutions" of the European Commission, IMF and ECB to complete their review and subsequently disburse the €7 billion in funding to Greece. Originally the Greek government had requested a six-month extension which would have

[21] These are profits generated from the ECB's holding of Greek bonds, which were purchased in previous years

[22] IMF staff report, "Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access", Jun 2014,p55,table 13, "fifth review"

[23] "Lack of trust hampers race to salvage Greece bailout deal", *Financial Times*, 17 Feb 2015

[24] Copy of letter from Greek finance minister to euorgroup obtained by the Financial Times, 19 Feb 2015

[25] "Germans rebuff Greek 'Trojan horse'", *Financial Times*, 19 Feb 2015

[26] Eurogroup statement on Greece, 20 Feb 2015

taken it to the end of August. Greece has two large bond repayments due to the ECB in July and August totalling €6.7 billion (£5.0 billion).

No reduction in debts

Greece will honour all of their financial obligations to those they have borrowed from.

Bank recapitalisation fund moved to Eurozone bailout fund

Funds of €10.9 billion (£8.1 billion) to support Greek banks will be moved from the Hellenic Financial Stabilisation Fund (HFSF) to the EFSF (Eurozone bailout fund) until the end of June and will still be available to Greek banks if needed. Greece had originally floated the possibility that it may want to use these funds for purposes other than bank recapitalisations.

Budget surplus target lowered for 2015

The primary surplus target – the budget balance excluding debt interest payments – for 2015, which was 3% of GDP, is scrapped and will now take "economic circumstances in 2015 into account". A lower surplus would, in theory, allow for higher government spending levels or lower levels of taxation. However, the public finances have deteriorated in the months prior to this agreement (tax revenues were €1 billion, or 23%, below its target in January)[27] meaning the old target would have been difficult to meet in any case.

Economic reforms to continue…

Greece commits to a "broader and deeper structural reform process", including implementing reforms to tackle tax evasion and corruption (problems Syriza has said it was keen to tackle).[28]

…with some flexibility added as Greece allowed to present its own measures

The Greek authorities have won the right to present their own package of reforms as part of this agreement. These were to be presented to the institutions (EU/IMF/ECB) by Monday 23 February, who will determine whether they provide a starting point for a more comprehensive list to be agreed by all parties at the end of April. This would then allow the institutions to complete their review and allow bailout funding to be disbursed to Greece.

The deal prevents the Greek government from making "unilateral changes" to previously implemented structural reforms if this would negatively affect the budget balance, as determined by the institutions. This presumably stops, at least in the short term, Syriza from implementing a number of the measures it had campaigned on during the election.[29]

Possibility of a follow-up arrangement after this arrangement ends

The Eurogroup statement also mentions that this extension can "bridge the time" – a term favoured by the Greek government – for discussions on the possibility of introducing another financial assistance programme once the current one ends.

Reaction and analysis of deal

This provisional agreement was viewed by most observers as a "defeat" for the Greek government given that most of its original demands that helped it get elected were not included.[30] For instance, *The Economist* concludes that "Greece drop[ped] nearly all its

[27] "Greek central govt surplus misses January target due to tax delays", Reuters, 12 Feb 2015

[28] See, for example, "PM Tsipras declares war at home on Greece's 'oligarchs'", Reuters, 17 Feb 2015

[29] This is summarised in their "Thessaloniki programme" of policies to reverse past austerity measures

[30] For a summary of opinion see "Tsipras Tamed as Economists Declare Greece Loses Austerity Fight", Bloomberg, 23 Feb 2015

demands".[31] The Open Europe think tank believes that "Greece seems to have failed to achieve many of its goals" with Greece "basically agree[ing] to conclude the current bailout".[32] Meanwhile, German Finance Minister Wolfgang Schäuble appeared content, commenting that "the Greeks certainly will have a difficult time to explain the deal to their voters".[33]

It appears that heightened concerns over the health of Greek banks put more pressure on the government to come to an agreement as quickly as possible. Reports suggest that over €1 billion in deposits were removed from Greece in the two days prior to the agreement.[34] News of the agreement has helped ease fears, at least in the short term, of capital controls being introduced to stop moving leaving Greece and has lowered the risk of Greece leaving the Eurozone.

Greek Prime Minister Alexis Tsipras in a television address to the country claimed that "We won a battle, not the war", while also warning that "The difficulties, the real difficulties ... are ahead of us." He and Finance Minister Yanis Varoufakis have said that this provisional agreement breaks the cycle of austerity that previous Greek governments had acquiesced to by introducing some flexibility to the conditions of the loans.

The four-month extension to the bailout, assuming it is not derailed, allows the two sides to hammer out a longer-term agreement should Greece remain unable to access international markets for its funding needs.

4 What happens next and unanswered questions

4.1 Implementation of 20 February agreement

As per the deal, the Greek authorities submitted their initial set of reforms to the Eurogroup of Eurozone finance ministers on Monday 23 February. These included a commitment to reform value-added tax (VAT) policy in order to boost revenues, fight corruption, reduce the number of government ministries, review and control public spending, and commit to not roll back privatisations that have been completed.[35]

The Eurogroup approved this list of measures on Tuesday 24 February. Noting that this was "a valid starting point" toward a more detailed list of policies that would need to be agreed by the end of April.[36] National parliaments of Eurozone members now need to approve this extension to the bailout. It is thought that this approval is very likely. The German parliament approved the bailout extension on Friday 27 February.

The Greek parliament will also need to approve the extension to the agreement. This is also thought very likely, but a few members of Syriza have expressed their anger at what they see as the party's failure to honour its election commitments.[37] The internal politics of Syriza, which is itself a coalition of radical left-wing groups, could influence the government's actions and negotiating position with its Eurozone partners.

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[31] "Greece and Europe: Outgamed", *The Economist* online, 21 Feb 2015

[32] Raoul Ruparel, "Greece bends to Eurozone will to find short-term agreement", Open Europe blog, 20 Feb 2015

[33] "Greece, euro zone agree four-month loan extension, avert crunch", Reuters, 20 Feb 2015

[34] "Greece, euro zone agree four-month loan extension, avert crunch", Reuters, 20 Feb 2015

[35] Greek government reform agenda sent to Eurogroup (23 Feb 2015), via *Financial Times* online

[36] Eurogroup statement on Greece, 24 Feb 2015

[37] "Greek bailout: Government reveals economic reforms – but Syriza dissenters says it has gone back on its election promises already", *Independent*, 23 Feb 2015

The IMF and ECB also signalled their approval of the Greek measures, although both expressed some reservations and emphasised that the measures were only a starting point.[38]

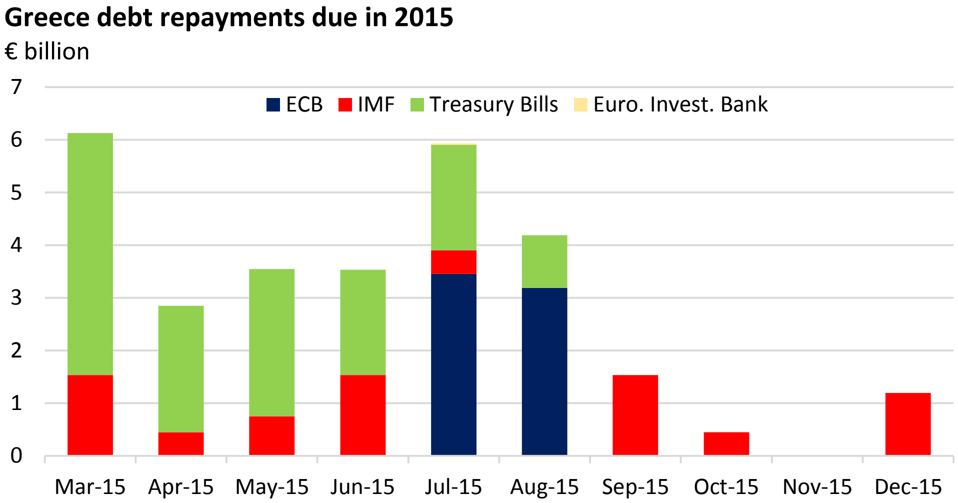
4.2 Funding issues

The reform proposals will now be fleshed out, with the final list of measures needing to be approved by the institutions – the European Commission, IMF and ECB – by the end of April at the latest. Until this review process is complete, the 20 February agreement states that there won't be any distribution of bailout funds to Greece.

This raises some questions about the ability of Greece to make a series of upcoming debt repayments (see chart below).[39] Greece is required to pay the IMF €1.5 billion in March, as well as having to roll over €7 billion in short-term government debt (treasury bills) in March and April combined. Treasury bills are mostly held by domestic banks, who will likely renew these loans when they mature in March and April.

As it appears that no further financial assistance from the bailout fund will be made until April at the earliest, questions are being asked as to how Greece will make these payments. While the government may have some reserves available, these are likely to be low. Indeed, Finance Minister Varoufakis acknowledged these concerns in a 26 February radio interview:

> "We will not have liquidity problems for the public sector. But we will definitely have a problem in repaying instalments to the IMF now and to the ECB in July."[40]



Source: Wall Street Journal, "Greece's Debt Due: What Greece Owes When", 19 Feb 2015

One possible solution would be for the ECB to lift the limit on Greek banks to hold government debt, which would allow them to purchase newly-issued government debt. This would enable the government to cover payments to the IMF for example.

Another funding squeeze looms immediately after the financial assistance programme ends at the end of June 2015. Greece needs to repay a total of €6.7 billion (£5 billion) to the ECB - for expiring Greek bonds they hold - in July and August.

[38] ECB, ECB letter to the Eurogroup, 23 Feb 2015 and IMF, Letter by IMF Managing Director Christine Lagarde to the President of the Euro Group on Greece, 23 Feb 2015

[39] Wall Street Journal, "Greece's Debt Due: What Greece Owes When", 19 Feb 2015

[40] "Greece faces problem repaying IMF, ECB - finance minister Varoufakis", Reuters, 25 Feb 2015

4.3 A third bailout?

If by the of the end of this new extended financial assistance agreement Greece is still unable to fund itself via international markets it will likely need a further, third, package of financial assistance. The Eurogroup statement following the 20 February agreement mentioned that the extension allowed time for “discussions on a possible follow-up arrangement”.[41]

These discussions are likely to be even more tense and difficult than was the case in February, as the legal conditions attached to the second bailout will have expired and the Greek government will likely wish to see much more of its election campaign promises, such as restructuring (reducing) some its debts, included. Against such a position, would the other Eurozone nations, and Germany in particular, be willing to agree to this, while simultaneously providing more funding? The question of whether Greece will stay or leave the Eurozone is far from settled.

[41] Eurogroup statement on Greece, 20 Feb 2015