Greece: Outplayed and out of luck

As news emerges of a possible deal between Greece and its creditors, Manulife Asset Management's Chief Economist, Megan Greene assesses what the news means for Greece and the eurozone.

Monday morning's headlines were full of news of a deal for Greece. But there is no deal. There are a series of punitive demands Greece must legislate by Wednesday or take a "time-out" from the eurozone. Once these demands are legislated, then Greece and its creditors will talk about a deal. That deal will almost certainly be an insurmountable challenge for both political and economic reasons. The immediate risk of a Grexit may be slightly lower following the summit conclusion this weekend, but the overall risk of a Grexit is materially higher.

Absent from the all-night negotiations this weekend was any real buy-in from either side of the negotiating table. Creditors have waxed on for years about how it is necessary for Greece to assume "ownership of the program" in order for it to succeed. Never has this been more the case than now. Any deal agreed for Greece will involve a fiscal adjustment so swingeing that Greece is likely to be in recession for at least the next two years. It will be extremely difficult for the Greek people to accept such an adjustment off the back of five years of economic depression. The medicine will be particularly bitter for Greeks to swallow given that the majority of people rejected such measures only one week prior in a referendum. Wolfgang Munchau, writing in the Financial Times, sums it up best when he asks: "do you really think that an economic reform programme, for which a government has no political mandate, which has been explicitly rejected in a referendum, that has been forced through by sheer political blackmail, can conceivably work?"[1]

There is no real buy-in for a deal on the German side either. The German finance minister went to the eurogroup this weekend with a proposal to give Greece a "time-out". This proposal was kept in the eurogroup conclusions – albeit in parentheses because not every country could support this approach. At the leaders' meeting last night, German Chancellor Angela Merkel and Greek Prime Minister Alexis Tsipras concluded that a Greek exit from the eurozone was the only realistic option. This does not inspire confidence that the German Chancellor is committed to keeping the eurozone together.

Another political consideration is the disintegration of the Greek political scene over the past few years. New Democracy and Pasok were hit hard in the polls during the general election in January given their involvement in the first and second bailouts.

The Greek people gave the Syriza party a mandate to push back against austerity and stand up for Greek dignity. However, Tsipras has had to completely cave on every election promise he has made. Syriza will almost certainly be unable to legislate the terms demanded by the creditors without support from the opposition parties. A coalition of national unity, led by Tsipras, is likely to emerge by the end of the week with new elections in the autumn. Such political instability could certainly get in the way of trying to push through what will be extremely unpopular and difficult measures.

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[1] "Greece's brutal creditors have demolished the eurozone project." *Financial Times*. 13 July 2015.

Even if there were buy-in from Greece and the creditors for a deal and the Greek government manages to legislate the demanded reforms, there is huge implementation risk. It is hard to see how a government that came to power vowing to push back against austerity measures will do a better job at implementing them than previous governments that were more amenable. Beyond this general scepticism, I have two main concerns.

First, in order to hit its primary surplus targets, Greece must boost its tax revenues. Back in 2010, it was true that many Greeks evaded taxes and so there was the hope that the tax haul could be fairly easily increased by catching more Greeks in the net. After losing one-quarter of its economy over the past year, however, Greece is so far along the Laffer curve[2] that an increase in taxes could be counterproductive. The issue is no longer that Greeks won't pay taxes, but rather that they can't pay them. Tax revenues are reported in a timely manner in Greece, so we will know fairly quickly if streamlining the VAT system and broadening the tax base has any positive effect on Greek tax revenues.

Second, part of the financing for a third bailout is set to come from a EUR50 billion fund financed by Greek asset sales. Privatization has been a notoriously thorny issue for the Greek government – there have been almost as many heads of the privatization fund as actual privatization deals over the past few years. In any case, we can be sure that any privatizations will be fire sales, and so even if Greece manages to privatize all the assets earmarked for the fund, the revenues will likely come in below target. This matters in particular because the banks will be recapitalized with half the proceeds from these privatizations. If capital controls are maintained for a while – and I expect them to be in place for years – and some deposits slowly trickle back into Greece through time, then, in theory, bank recapitalization does not have to happen immediately. Greek bank non-performing loans (NPLs) already exceeded 40% a few weeks ago and are no doubt significantly higher now. The longer one puts off crystallizing those losses, the bigger the potential losses get. It would undoubtedly be in Greece's best interests to recapitalize the banks immediately, but progress on this will likely be slow, given the funding source.

Prospect of more sleepless summits in Brussels

What is clear for Greece from the outlines of the deal is that the Greek government was badly outplayed in Brussels this weekend. Even if Greece avoids political collapse in the next week, legislates immediate measures and signs up to a third bailout with the creditors, it unlikely we will get too far before the third bailout goes the same way as all the others: off track. The tone and content of the negotiations over the weekend suggest it will only be a matter of months before we are back to sleepless summits in Brussels, but at that stage, trust on both sides will probably be in even shorter supply than it is now.

[2] The Laffer curve is one possible representation of the relationship between rates of taxation and the hypothetical resulting levels of government revenue.