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Who can save Greece?

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After two months of heated debate among policy-makers and intense speculation in the markets, the basic conditions for the joint International Monetary Fund/European Union rescue operation for Greece have now been decided. But will this package be sufficient? A closer look shows that it can at best tide the country through a rough patch; the underlying problem will remain.

The size of the (still only putative) rescue package amounts to about €45 billion of which less than a third will come from the IMF. The extended discussion over whether the IMF should get involved in an intra-EU problem was always a red herring. The contribution of the IMF had to remain marginal given that its programmes are usually limited to 10-15 times the borrower's 'quota' at the Washington Institution, which in the case of Greece is set at €900 million. Even in the case of Iceland, which faced a total collapse of its banking system, the IMF refused to lend more than 13 times the country's quota.

The interest rate to be charged to Greece has also been the focus of attention for some time. It has now been fixed at 5%, or about 200 basis points below the rates Greece might have to pay in the market for longer-term funds.

However, the beneficiary of the package seems to be wary of activating it – and for good reason. The official condition stipulated for receiving the funds is that the euro area financing mechanism "has to be considered ultima ratio, meaning in particular that market financing is insufficient". For Greece to activate the IMF/EU package is tantamount to officially announcing to the markets that the country is insolvent. The package could thus constitute a trap. Substantial official financing tends to increase the risk premium required by the markets given that official financing is senior to private sector claims, thus lowering the funds available for private sector creditors in the case of default or restructuring.

Moreover, the package, while substantial, was designed to cover the financing needs of Greece for the remainder of this year. At least an equivalent sum might again be needed next year. So why all this fuss about a package that provides Athens with breathing space of only a couple of quarters?

The usual argument is that Greece needs official financing to lower the interest burden. But a few simple calculations show that this cannot be decisive. With the offer of the EU financing now agreed, Greece might save about €900 million a year, a tiny fraction of the (cash) deficit of the Greek central government of €40 billion last year.

This key point is often overlooked: the interest rate to be charged to Greece is a side issue. Even if the Germans had been much more generous and accepted a rate of 4% (which would have been below the rates

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paid by Portugal), Greece would have saved on this package €450 million per annum more, equivalent to less than 0.2% of its GDP.

By comparison, the overall adjustment in the deficit needed for Greece's debt-to-GDP ratio to stabilise is usually taken to be 10-12% of GDP. Interest savings on official financing make very little difference. The bulk of the adjustment effort has to be made by Greece itself.

Greece has funded its debt mostly with long-term instruments, so it only has to refinance about €30 billion a year. Assuming that its deficit can be reduced to 8% of gross domestic product, this would imply an overall financing need of about €50 billion per annum. The real problem of Greece is thus not one of liquidity, but one of solvency.

Further EU financial packages would make a material difference only if they were to cover all of Greece's financing needs over an extended period at significantly below market rates. But this is not likely to happen because it is exactly what the 'no bail-out' clause was meant to preclude.

The key issue that will remain for years to come is whether Greece is willing to undertake the huge domestic effort required to achieve a sustainable fiscal position. As long as doubts remain on this account, the spreads on Greek debt will remain elevated irrespective of the exact terms of international rescue packages. The fate of Greece will be decided in Athens, not in Brussels or in Washington.