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Thinking ahead for Europe

The Greek Austerity Myth

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Since the victory of the anti-austerity Syriza party in Greece's recent general election, the 'Greek problem' is again preoccupying markets and policy-makers throughout Europe. Some fear a return to the uncertainty of 2012, when many thought that a Greek default and exit from the eurozone were imminent. Then as now, many worry that a Greek debt crisis could destabilise – and perhaps even bring down – Europe's monetary union. But this time really is different.

One critical difference lies in economic fundamentals. Over the last two years, the eurozone's other peripheral countries have proven their capacity for adjustment, by reducing their fiscal deficits, expanding exports, and moving to current-account surpluses, thereby negating the need for financing. Indeed, Greece is the only one that has consistently dragged its feet on reforms and sustained abysmal export performance.

Providing an additional shield to the peripheral countries is the European Central Bank's plan to begin purchasing sovereign bonds. Although the German government does not officially support quantitative easing, it should be grateful to the ECB for calming financial markets. Now Germany can take a tough stance on the new Greek government's demands for a large-scale debt write-off and an end to austerity, without fearing the kind of financial-market turbulence that in 2012 left the eurozone with little choice but to bail out Greece.

In fact, both of the Greek government's demands are based on a misunderstanding. For starters, Syriza and others argue that Greece's public debt, at a massive 170% of GDP, is unsustainable and must be cut. Given that the country's official debt constitutes the bulk of its overall public debt, the government wants it reduced.

In fact, Greece's official creditors have granted it long enough grace periods and low enough interest rates that the burden is bearable. Greece actually spends less on debt service than Italy or Ireland, both of which have much lower (gross) debt-to-GDP ratios. With payments on Greece's official foreign debt amounting to only 1.5% of GDP, debt service is not the country's problem.

The relatively low debt-service cost also removes the justification for Syriza's demands for an end to austerity. The last bailout programme from the 'troika' (the International Monetary Fund, the ECB and the European Commission), initiated in 2010, foresees a primary budget surplus (which excludes interest payments) of 4% of GDP this year. That would be slightly

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more than is needed to cover interest payments, and would thus allow Greece finally to begin to reduce its debt.

The new Greek government's argument that this is an unreasonable target fails to withstand scrutiny. After all, when faced with excessively high debt, other European Union member states – including Belgium (from 1995), Ireland (from 1991) and Norway (from 1999) – maintained similar surpluses for at least 10 years each, typically in the aftermath of a financial crisis. Even Greece itself was able to run a primary surplus of over 4% of GDP during the last half of the 1990s (see ECB, 2011). If the country was willing to accept these surpluses when preparing for EMU, one should be able to assume that the same policy should be acceptable as the price of staying in the euro.

To be sure, one can reasonably argue that austerity in the eurozone has been excessive, and that fiscal deficits should have been much larger to sustain demand. But only governments with access to market finance can use expansionary fiscal policy to boost demand. For Greece, higher spending would have to be financed by lending from one or more official institutions.

For the same reason, it is disingenuous to claim that the troika forced Greece into excessive austerity. Had Greece not received financial support in 2010, it would have had to cut its fiscal deficit from more than 10% of GDP to zero immediately. By financing continued deficits until 2013, the troika actually enabled Greece to delay austerity.

Of course, Greece is not the first country to request emergency financing to delay budget cuts, and then complain that the cuts are excessive once the worst is over. This typically happens when the government runs a primary surplus. When the government can finance its current spending through taxes – and might even be able to increase expenditure, if it does not have to pay interest – the temptation to renege on debt intensifies.

It was widely anticipated that Greece would be tempted to follow this route when the troika programme was initiated. Last year, the new Greek finance minister, Yanis Varoufakis, confirmed the prediction, arguing that a primary surplus would give Greece the upper hand in any negotiations on debt restructuring, because it could just suspend repayments to the troika, without incurring any financing problems.

That approach would be a mistake. The practical problem for Greece now is not the sustainability of a debt that matures in 20-to-30 years and carries very low interest rates; the real issue is the few payments to the IMF and the ECB that fall due this year – payments that the new government has promised to make.

But, to follow through on this promise (and hire more employees), Greece will need more financial support from its eurozone partners. Moreover, the country's financial system will need continuing support from the ECB.

In other words, Greece's new government must now try to convince its European partners that it deserves more financial support, while pushing for a reduction of its existing debt and resisting the austerity policies on which previous lending was conditioned. For Syriza and its voters, the political honeymoon could be short.

Reference

European Central Bank (ECB) (2011) (www.ecb.europa.eu/pub/pdf/mobu/mb201106en.pdf).