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17 August 2015

Why Germany is right to call for Greek reforms not debt cuts

by Michael Heise

Greece's third bailout programme – which is currently making its way through European parliaments – could underpin a swift recovery in the country, provided, of course, political turbulences do not derail the programme once more. While the new bailout and reform package is being passed, the debate about the need for outright debt cuts is heating up. The German government is however refusing upfront debt restructuring in order to keep up the reform momentum in Greece. There are good reasons to stick to this stance.

The Greek government has important supporters in demanding further sovereign debt reduction. The International Monetary Fund insists on official sector debt forgiveness as a precondition for getting involved in the third bailout programme. Many influential economists criticise the German government for its reticence in this matter. The Greek economy, they argue, is so weak that it will buckle under €300 billion of sovereign debt. Greece will simply not be able to repay such sums. Only major debt relief can rekindle economic growth, which, in turn, should enable Greece to service a more moderate level of debt. Some supporters of debt forgiveness add a moral argument: most of the bailout money was used to prop up banks in Europe's richer core countries. Why should the poor Greek population now suffer to repay it?

Let's look at the facts. First, Greece has already received massive debt relief: in 2012, €107 billion in private sector debt was written down. Second, on most of the remaining debt, Greece pays no interest, nor does it have to repay any principal until 2020. In economic terms, therefore, it is simply not true that the debt burden is "unbearable". The ESM has calculated the cost of these interest rate reductions and maturity extension to figure 90 bn Euro. The third bailout programme will lower the debt burden even more: €50 billion will be used to refinance expensive existing debt through loans with very long maturities (probably 32.5 years on average), minimal interest rates and substantial grace periods.

Third, it is not the case that most of the money that Greece has borrowed since 2010 was used to bail out foreign banks. True, at the beginning of the crisis, especially before the 2012 haircut, foreign and Greek banks benefited from the international bailouts that allowed the Greek government to continue servicing its debt. But since then, most of the money was used to support Greece itself. Some €50 billion went directly into the Greek budget since 2010. Without this money, the government would have had to cut investment and social spending even more, or raise taxes drastically. Another €37 billion was used to recapitalise Greek banks in 2012, which was meant primarily to protect local saving deposits. By that time, the exposure of foreign banks to Greek banking had become minimal.

Finally, the money that the European Central Bank has lent to Greece (€108 billion to date) has enabled the Greek people to continue importing goods and investing abroad. From a macro-economic perspective, it might be questionable whether the ECB should have supported "capital flight". For the individual Greek, however, it was a blessing.

Now to the question whether Greece needs further relief to make its debt sustainable. The answer fundamentally depends on how much the Greek economy will grow in coming years. Growth is not being held back by an "unsustainable" debt burden, as I explained. Cutting debt on which Greece currently pays neither interest nor principal would not have much of an impact on the Greek debt burden and on growth. Instead, economic prospects depend on the willingness of the Greek government to improve business conditions and make the public sector more efficient. Therefore, the German government is right when it remains cautious about immediate further debt relief. If the debt is cut now – before the creditors have proof that this time Greece is serious about reform – the pressure on Tsipras to implement reforms will disappear. For the Greek people that would be a tragedy. If, however, Greece follows through on the promises it has made to obtain the third bailout, its chances of economic revival and growth are good. Other eurozone countries have provided ample proof for that.

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