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Greece's Arrears-Driven Crisis

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OVERVIEW

Bottom Line: If the past is any guide, the decisions now confronting the Greek government about who to pay and who not to—the politics of arrears—will present a critical challenge and likely define the future path of the crisis.

As the Greek government scrambles to find a reform package that all parties can agree to, focus has turned to the government's dwindling funds and mounting payment pressures. These include an April 9 payment to the International Monetary Fund (IMF) for $450 million and two treasury bills totaling 2.4 billion euros that Athens must roll over in mid-April, a challenge complicated by the significant holdings of external investors. But domestic payments are the more immediate and pressing challenge. In order to pay March wage and pension benefits, the government has been forced to tap the reserves of pension funds, state bodies, and utilities and delay payments to farmers, medical providers, and suppliers, among others. Going forward, Greek officials are reportedly considering the use of IOUs for the payment of salaries and pensions. Less politically sensitive payments to suppliers are likely to continue to lag, though pressure to make them will probably mount in coming weeks. In his letter to German Chancellor Angela Merkel last month, Greek Prime Minister Alexis Tsipras signaled that his government would not have sufficient resources without new assistance and would not make debt payments at the expense of social stability.

> *The decision to pay some creditors and not others involves allocative choices that are often new terrain for governments.*

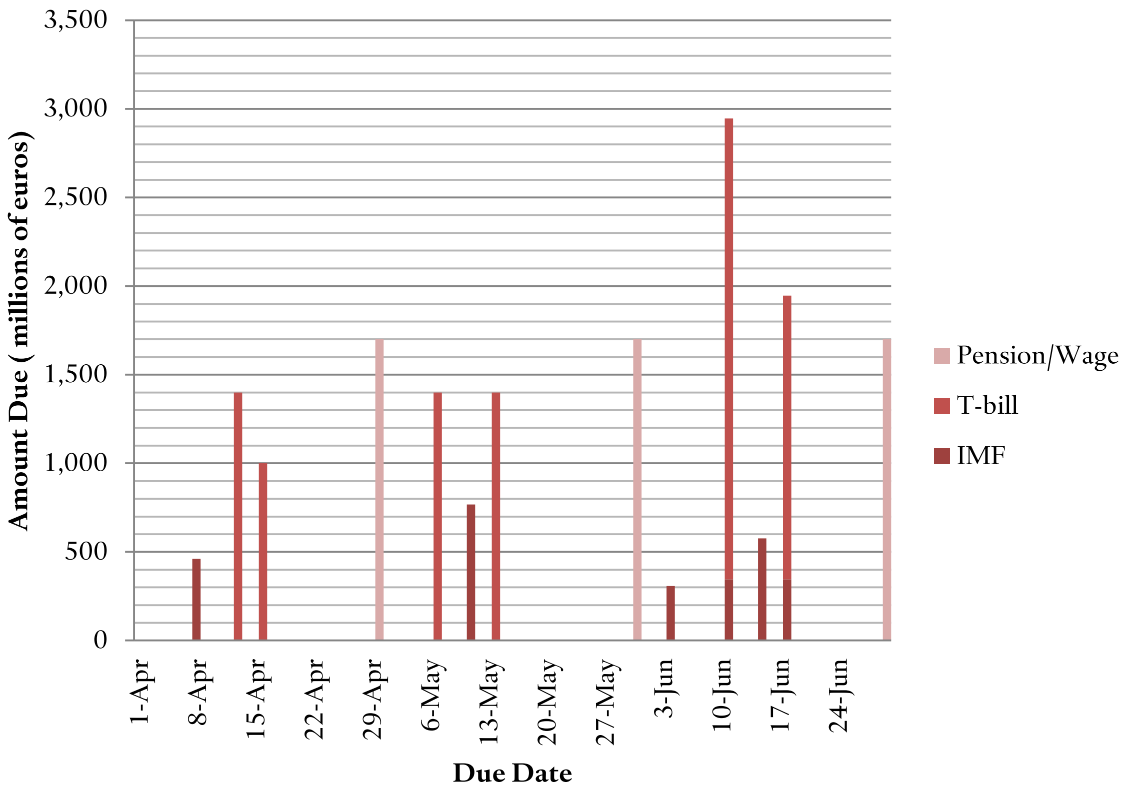
HOW DID WE GET HERE?

Tax revenue collapsed in the run up to the January 2015 election, and has contracted further in the uncertainty that has followed. In recent weeks, the Greek parliament has approved a number of anti-poverty measures and a payment plan for tax debtors, generating domestic support but taking policy further away from the previously approved program. It is unclear whether more controversial, but necessary, reforms could win approval. As a result, even the reduced government primary surplus of 1.5 percent of gross domestic product (GDP) looks out of reach under current policies. Western creditor governments have made it clear that they are prepared to finance Greece, but need a willing partner to craft a coherent and sustainable economic plan. This is not to criticize the government for seeking to keep its election promises, but rather to stress the large and growing gulf between its plans and what European creditors are willing to support. Unsurprisingly, bank deposits have begun to flow out of the system in past weeks (reportedly as much as 350 million to 400 million euros on some days), exacerbating liquidity problems.

LESSONS FROM EMERGING MARKETS

Running substantial arrears is a common feature of past emerging-market crises. The decision to pay some and not others involves allocative choices that are often new terrain for governments, and damage their capacity to operate efficiently. Suppliers and other providers of government services see arrears differing across sectors depending on the power of the relevant ministries and the revealed priorities of the government. IOUs might circulate but tend to trade at deep discounts given poor liquidity conditions. Capital controls can be necessary to stem flight, putting further strain on the economy. Fissures within governing coalitions can open up. This process is rarely structured or orderly.

FIGURE 1: GREEK PAYMENTS DUE IN THE SECOND QUARTER OF 2015



Data Sources: Financial Times, Wall Street Journal.

In such situations, it is not uncommon to see arrears exceeding 5 percent of GDP. (This was true in Greece in 2012.) In crisis that number could climb quickly. In the run-up to Russia's 1998 crisis, wage and interfirm arrears paralleled a weakening of budget discipline and were reflective of what the IMF came to call a "culture of non-payment" that undermined support for continued adjustment and was an impediment to recovery. In Argentina, after the introduction of banking-sector controls in December 2001, arrears at the federal and local level mounted quickly. Paper IOUs issued by governments traded at deep discounts, and eventually most liabilities of the government and private sector were written down at preferred rates as part of an "asymmetric repesofication" by the government. A third example comes more recently from Venezuela, where the moral and political consequences of continuing to pay external debt at a time when the government was running comprehensive domestic arrears and rationing foreign currency generated a firestorm of debate. Getting out of arrears is a challenging task in the best of circumstances, though there are examples, including recently in Portugal, of governments implementing programs to resolve arrears as a central part of their crisis response.

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WHAT COMES NEXT?

The Greek government would like to tap EU bailout funds, but acknowledges that will take time. The government intends to introduce reforms this week that it hopes will unlock additional assistance, but all the signals are that these proposals are the start of what is likely to be a drawn-out negotiation. In the interim, it is looking for the European Central Bank (ECB) to provide financing—primarily though the Bank of Greece's emergency liquidity assistance (ELA) mechanism, which now stands at around 70 billion euros—to illiquid Greek banks, which in turn can buy government paper. There should be no mistake that to do so would be pure fiscal financing. Consequently, it is not surprising that the ECB has opposed lifting the 3.5 billion euro cap on the amount of T-bills it will accept as collateral in exchange for central bank loans.

> *The political timeline is measured in months, while the economic timeline is measured in days.*

TAKING THE RIGHT MESSAGE FROM GREECE'S PROBLEMS

I am struck by how sanguine most analysts are about the crisis in Greece and its implications for the rest of Europe. Today, many experts argue that a deal that allows Greece to muddle through and avoid an exit from the eurozone ("Grexit") is the most likely outcome. This argument is usually based on the assessment that there is a deal to be had, that Prime Minister Tsipras is a realistic leader who can over time navigate his coalition to a course that balances democratic accountability and a return to growth with the reforms needed to continue to receive assistance, and that both sides have too much to lose from a messy exit.

All this may be true, but the political timeline over which this scenario plays out is measured in months, while the economic timeline is measured in days. Any agreement reached will require approval by the Greek and foreign parliaments. Interim meetings can at best provide momentum to negotiations that justify ECB financing while these negotiations proceed.

In the meantime, the future course of this crisis is likely to be altered by how Greece grapples with the politics of arrears. The perception that some groups have preferred access to scarce government resources—especially if decisions are made in a chaotic or nontransparent fashion—could strain the coalition and highlight the gap between campaign promises and reality. Ultimately, exit from the eurozone may be the only way to resolve these tensions and deal with accumulated insolvency. Conversely, strong governance in managing arrears, coupled with accelerated and realistic negotiations with its official creditors, can strengthen the government's standing domestically and create the basis for an economy-wide consensus on adjustment within the eurozone. Although the outcome is by no means foreordained, the challenge of avoiding chaos eventually leading to Grexit is becoming more difficult by the day.

Looking Ahead: Kahn's take on the news on the horizon

Ukraine struggles to cut a deal
Ukraine's negotiations with its private creditors are likely to prove difficult and an end- of-June deadline looms. The prospect of a debt moratorium has risen.

More rate hike delays
Soft inflation data (and rising Greek risk) suggests the Federal Reserve can wait beyond June to begin hiking rates, but a 2015 liftoff still looks likely.

Much-needed recovery for Europe
European growth finally surprises on the upside, boosted by cheap oil and a weak euro, but voters may not feel a recovery.