Greek Bailout Solution. Unlikely To Work. And a Proposed Solution.

14 July:

It’s not over. The deal agreed by the Eurogroup with Greece will need the creditor parliaments and the Greek parliament to vote and approve before the governors of ESM can approve it. The Greeks will likely approve it although Tsipras 149 votes will likely not all be yes, it is expected some 30 will vote against, the 106 pro Euro opposition will be sufficient to carry the motion. As for the creditors, only Finland looks risky. Under normal circumstances an ESM bailout requires unanimity but the ECB can and in the event of dissent will likely decide that the action is a threat to the stability of the union and force the vote into a special motion requiring an 85% majority. The potential dissenters will unlikely get beyond 3% of the vote. And so the Greek bailout will likely be ratified.

The ESM’s response to the proposal is not unequivocal and there are potential uncertainties in the language which suggest that there could be further negotiations.

While in the short term the deal will likely be approved by the Greek parliament the fact that the deal Tsipras has achieved is worse than the June 26 creditor proposal and indeed worse than any deal in the negotiations thus far poses a risk to his leadership. The deal involves no debt write down, no end to austerity, a restart to asset sales and this time under the strict supervision of the Troika and the continued monitoring of progress by the creditors, something that was deemed humiliating and demeaning. Syriza is itself a coalition and the integrity of this coalition must certainly come under pressure given the quality of the bailout deal. One can reasonably expect a shakeup in the Greek parliament and possibly new elections.

Even assuming that all parties were agreeable it is difficult to see how Greece would comply with the budget targets. It is one thing to agree to something but another to have a plan to achieve it. So far both creditor and debtor have focused on targets without devising the means to achieving them. Few countries have achieved what the Greeks are aiming for, not even their largest creditor Germany.

The probability that Greece gets into a financially distressed situation at some stage in the not too distant future, under this plan, is quite high.

15 July:

Having had time to sleep on this I'm beginning to have doubts that the Greek parliament will pass it. Tsipras began with an anti-austerity platform and coalition party. He's now ended up with a tighter austerity program than he bargained for at the start of negotiations. Parts of Syriza will vote against the creditor plan. He is counting on the opposition to support this pretty draconian plan. Now the opposition may have been for austerity when they thought it might work but the capital controls have taken the Greek economy off the cliff, not near it, off it. ELA is frozen, thankfully not retracted, and with TARGET2 off limits the Greek economy is essentially is containment. I am simply not sure anymore if the opposition New Democracy will support what is an unworkable creditor plan.

The plan itself is incomplete, which under these dire conditions is actually a source of hope. As it stands, without a write down, the plan is unworkable and seems to have been put together either by amateurs or creditors seeking Chapter 7 instead of Chapter 11. Trying to raise cash by selling assets is a great idea on paper but is impractical. Once the seller is identified as a motivated seller, the bids will tumble to fire sale levels that no credible creditor would agree to if they believed they had claim to such assets and their proceeds of sale. If the sale program was sufficiently determined, the proceeds will fall well short of the 50 billion EUR envisaged. If the sale was attempted at reasonable prices, the fact that the assets for sale are earmarked for sale would mean that the deals will not get done and it is likely that there will be recriminations over the speed of the asset sales and the motivation of the debtors or the creditors.

A credible plan would see the following principles:

1. As close as possible to a commercially viable deal that an arms length investor would fund.
2. A long term solution as long as the longest maturing debt that will be issued as part of the restructuring.

My plan would include:

1. Debt restructuring:
* Issue of senior secured bonds with first claim to a proportion of tax revenues and a sinking fund under control of creditors.
* Issue of senior unsecured bonds with zero coupons for first 10 years and coupons stepping up thereafter.
* Issue of mezzanine GDP linked bonds.
* Legacy bonds to be written down by X% with immediate effect and the recovery value financed by the new bonds above. X could be substantial, circa 30%-50%.

2. Pension reform.
* No new defined benefit pensions to be issued. All defined contribution schemes to be frozen (not cancelled) at this point (that is, any indexation to stop.)
* Introduction of defined contribution pensions. Employers pay 15%, employees pay 15%. Assets held in an independent safe custody vehicle beyond the reach of government or state.
* Phased withdrawals of state pensions. Private annuity options.
* Medical insurance part funded from this pool.

3. Social security.
* Unemployment benefits and other social welfare benefits separately funded by payroll taxes.
* Medical insurance part funded from this pool.

4. Taxation.
* VAT proposed in current creditor plan.
* Corporate taxes to be cut when possible. Ideally 1% cut each year in primary surplus till 20%.
* Tax holiday for specific industries – tech, biotech, industries likely to bring investment.
* Social security tax for employers cut from 28% to 10% to compensate for 15% contribution to employee pension fund.
* Social security tax for employers replaced by compulsory pension contribution. This is a simple reclassification.
* Personal allowance of 5,000 EUR.
* 2% cut to all marginal income tax rates.

5. Investment.
* Infrastructure investment funded by private participation in infrastructure bonds and equity.

6. Anti-corruption.
* Anti-corruption campaign. This to address tax collection and tax liability as well as general rule of law.

7. Financial system recapitalization.
* The banking system will have to be recapitalized. That much is clear. The recapitalization will have to come from first from the government and then from private sources. The banks will issue equity underwritten by the government and simultaneously issue tier 1 capital and mezzanine debt.

The government’s biggest expenses are on pensions, medical insurance and social security. By moving from defined benefit to defined contribution, the burden of pensions is shifted to the people, as it should. Medical insurance is split between being funded by the pension pool (individual responsibility) and the social security pool (collective responsibility). These measures will lessen the collective burden and improve the state finances allowing for a reduction in marginal tax rates.

If the creditors are unhappy with the debt write-down and the issue of further debt and the latitude for Greece to run smaller surpluses or indeed small deficits in an interim adjustment period, then they should just eject Greece from the euro.