Greek Crisis: Mr. Tsipras blinks

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In the 11th hour before Grexit, Euro area leaders reached agreement on a third rescue package for Greece last night. The deal would be finalized only after the Greek parliament legislates tough reforms in the next two days, including tax increases, pension reform, judicial reform, cuts in defense spending, independence of the revenue collection agency and the statistical service, and the EU bank recovery and resolution directive. Additionally, the Greek government needs to make specific commitments on market-opening measures in goods and services markets, public sector and labor market reforms, privatization and non-performing loans. The package includes contingent fiscal measures to compensate for any spending overruns or revenue shortfalls, and a commitment to transfer state-owned assets worth several billion to a Luxembourg-based entity controlled by creditors. Further scrutiny over the next few days probably will focus on the adequacy of the fiscal adjustment and the structural reforms needed to make the Greek economy competitive within the Euro area. Difficult discussions around debt relief also loom, though they will not be initiated until Greece delivers on reform. The fiscal drag implied by the program is so large that the creditors would need to put on the table the €35bn investment package over 5 years (partly funded by the European Investment Bank) that President Junker had already promised in order to provide offsetting fiscal stimulus.

How did we arrive at such a tough and bold reform program only days after Greek voters delivered a resounding “No” to a far more modest proposal on July 5? After a five-month standoff, Mr. Tsipras abruptly announced a referendum on Friday 26 June, four days before the EU/IMF-funded program was due to expire.

European leaders were stunned by the announcement in the midst of ongoing negotiations in Brussels, but accepted it as a democratic right of the Greek people. Finance Minister Tsakalotos admitted with disarming honesty on CNN that the referendum was called because the deal under negotiation was unlikely to be accepted by SYRIZA's parliamentary majority. Mr. Tsipras chose to divide the Greek people through a referendum instead of risking his parliamentary majority. The immediate consequence was the closure of banks and the imposition of capital controls as of Monday 29 June to forestall massive deposit withdrawals ahead of the referendum. Greek banks remain closed since then, with people queuing to withdraw 60 euros a day from ATMs.

Mr. Tsipras had not anticipated the closure of the banks. He erroneously believed that the ECB would continue to provide liquidity ahead of the referendum despite the near-certainty of massive deposit withdrawals. When the program lapsed on June 30, he was forced to accept the terms he called "absurd" only days ago. But the following day he blasted the creditors for blackmailing the Greek people and urged voters to reject the creditors' terms in the referendum. No wonder European leaders do not trust him to implement any agreement – an issue that came back to haunt him in yesterday's tense negotiations.

After a resounding "No" result in the referendum (61% vs. 39%), Greece was given an ultimatum to reform or leave the Euro area. Faced with imminent catastrophe, Mr. Tsipras blinked. On July 9, he requested a three-year rescue package from the European Stability Mechanism and gave in to practically all the terms the creditors had demanded in order to extend by a few months the program that ended on June 30. The request was based on creditor proposals predating the lapse of the program, focusing on fiscal measures needed to reach primary surplus targets of 3.5% of GDP over the medium term, with the exact path to be reviewed with the troika institutions in light of recent economic developments. But his last-minute offer was not good enough: the terms did not take into account the fallout of the bank closure and capital controls; more importantly, they did not measure up to the deep reforms Greece needs to undertake to modernize its economy. Creditors therefore raised the bar on the reforms needed to return Greece to sustainable growth and market financing within three years. Germany even proposed a five-year time out from the Euro area, while Greece implemented reforms.

So what is the result of the five-month standoff? A projected economic recovery has turned into a double-dip recession, with GDP growth turning negative again this year after a modest recovery in 2014. The closure of the banks has inflicted permanent damage, as the loss of confidence implies that capital controls will remain in place for months or even years after the banks re-open (they remained in place for two years in Cyprus). Fiscal measures needed to reach modest fiscal targets reportedly amount to €12-14bn, compared with just €2bn demanded by creditors last November, when growth was projected at 2.5% this year. Rescue

costs have risen to about €85bn, including €12bn needed in the next month to meet payments due to official creditors and €10bn up front for bank recapitalization, in order to ensure solvency and enable the ECB to continue funding the Greek banks.

Predictably, the game of chicken Mr. Tsipras has been playing ended with suicide, including his own. When Mr. Tsipras was elected in January 2015, analysts wondered if he would turn out to be a Lula or a Chavez. Although his fiery rhetoric resembles that of both leaders, he turned out to be neither. Unlike Mr. Lula, he did not reform his country, nor did he gradually turn it into a centrally planned economy like Venezuela. He is a failed leader who overplayed his hand thinking that creditors would blink for fear of Grexit. They didn't. As every good game theorist knows, threats must be credible. Last Friday, when Mr. Tsipras asked parliament to give him the authority to negotiate with creditors, he tried to sell the proposed deal as an improvement over the one rejected by voters because it included debt relief and excluded the "tough" IMF from the troika. But debt relief will only be considered after the first review is successfully concluded and the IMF will remain in the troika at the insistence of the Germans. Mr. Tsipras already lost his parliamentary majority after Friday's vote. Without even a fig leaf to hide behind, he should resign, but only after he ensures that the prior actions required by the program are approved by parliament and a national unity government is formed. Hybris meets nemesis.