Journal of European Public Policy

ISSN: 1350-1763 (Print) 1466-4429 (Online) Journal homepage: https://www.tandfonline.com/loi/rjpp20

Puzzled out? The unsurprising outcomes of the Greek bailout negotiations

Darren J. Lim, Michalis Moutselos & Michael McKenna

To cite this article: Darren J. Lim, Michalis Moutselos & Michael McKenna (2019) Puzzled out? The unsurprising outcomes of the Greek bailout negotiations, Journal of European Public Policy, 26:3, 325-343, DOI: 10.1080/13501763.2018.1450890

To link to this article: https://doi.org/10.1080/13501763.2018.1450890

© 2018 The Author(s). Published by Informa UK Limited, trading as Taylor & Francis Group

View supplementary material

Published online: 23 Mar 2018.

Submit your article to this journal

Article views: 3142

View related articles

View Crossmark data

Citing articles: 5 View citing articles

Full Terms & Conditions of access and use can be found at
https://www.tandfonline.com/action/journalInformation?journalCode=rjpp20

JOURNAL OF EUROPEAN PUBLIC POLICY
2019, VOL. 26, NO. 3, 325–343
https://doi.org/10.1080/13501763.2018.1450890

Routledge
Taylor & Francis Group

OPEN ACCESS Check for updates

Puzzled out? The unsurprising outcomes of the Greek bailout negotiations

Darren J. Lim [a], Michalis Moutselos [b] and Michael McKenna [a,c]

[a]School of Politics and International Relations, Australian National University, Canberra, Australia; [b]Max Planck Institute for the Study of Religious and Ethnic Diversity, Göttingen, Germany; [c]College of Engineering and Computer Science, Australian National University, Canberra, Australia

ABSTRACT

While to date the Eurozone debt crisis is one of the most important and consequential events in world politics of the twenty-first century, the actions taken by states to negotiate a cooperative resolution do not seem particularly puzzling. In this article, we employ the analytic explanation approach to process tracing to test whether the most protracted and high-profile case – negotiations between creditors led by Germany, and Greece as debtor state – indeed validate three central hypotheses of basic cooperation theory regarding the sources of bargaining strength. We conclude that while bargaining leverage did emerge primarily from the ability to withstand non-agreement, the weaker Greece was able to achieve marginal concessions reflecting terms that departed from Germany's initial win-set. This leverage stemmed however not from a threat based on domestic political constraints, but from the realization that Greece's structural economic weakness rendered the strictest austerity measures untenable. The policy implication is that the credibility of the weaker side's negotiating signal arose not from domestic politics, but the impartial assessments of international technocrats and private rating agencies.

KEYWORDS Bargaining; credible signaling; cooperation; debt crisis; Eurozone; two-level games

Introduction

The Eurozone debt crisis that began in 2010 placed the members of the currency union in a precarious position. At several critical junctures, Eurozone governments and institutional partners were urgently required to negotiate cooperative agreements designed to achieve two related goals: preserving the solvency of severely indebted periphery governments facing sovereign debt defaults, and thereby protecting the value of that same debt held by

CONTACT Michalis Moutselos moutselos@mmg.mpg.de

Supplemental data for this article can be accessed at http://dx.doi.org/10.1080/13501763.2018.1450890.

© 2018 The Author(s). Published by Informa UK Limited, trading as Taylor & Francis Group
This is an Open Access article distributed under the terms of the Creative Commons Attribution License (http://creativecommons.org/licenses/by/4.0/), which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

banks from the Eurozone's core. Failure to do so risked terrible consequences: sovereign defaults, widespread bank failures and the possible collapse of the Euro. To avoid this calamity, creditor governments would need to provide injections of funds to finance the budget deficits of insolvent debtor governments. To address inevitable moral hazard problems, in return debtor governments had to implement harsh austerity measures, which would also serve to stabilize public finances and restore the confidence of international financial markets. Implementing this two-pronged approach posed significant technical and political hurdles. Technically, the negotiated agreements had to be robust enough to assure international financial markets of the long-term viability of periphery public finances. Politically, the agreements had to survive significant domestic opposition and its attendant electoral consequences within both debtor and creditor nations. Yet despite numerous doomsday predictions, at each juncture negotiators found a way to agree, staving off the insolvency of debtor governments and in doing so potentially saving the entire single currency project.

Scholarship focusing on these momentous events is beginning to emerge (Hennessy 2017; Matthijs 2016; Pitsoulis and Schwuchow 2017; Schimmelfenning 2015; Schneider and Slantchev 2018; Tsebelis 2016; Zahariadis 2016a, 2016b). In light of the basic theoretical approaches to bargaining and cooperation, it is notable how *unsurprising* the most important outcomes were. As an example of creditor–debtor negotiations, with dynamics somewhat paralleling the 1980s debt crises in Mexico and Brazil, the headline outcomes from Eurozone agreements appear to conform to orthodox expectations. Consider the most high-profile negotiations between creditors led by Germany, and Greece as the debtor: each side came to the negotiating table with win-sets defined by domestic politics, with governments on both sides incentivized by economic interdependence to agree on a bailout deal. Yet creditors enjoyed a greater capacity to withstand the costs of non-cooperation and this asymmetric interdependence meant that negotiated outcomes predominantly reflected German preferences (Schimmelfenning 2015).

Is that the end of the story? In this article, we employ evidence from the three discrete bailout agreements concluded between Greece and its creditors, led by Germany, in 2010, 2012 and 2015 to test three basic hypotheses from cooperation theory in the context of international debt crisis negotiations. The first is that bargaining strength arises from the capacity to withstand the costs of non-agreement (Fearon 1998) – or, that Germany was always going to 'win' against a financially crippled Greece. The second is the 'Schelling Conjecture' – the claim that even the weaker side in a negotiation can achieve a relatively more beneficial outcome by credibly tying its hands, in this case by arguing that the final agreement is subject to domestic constraints (Putnam 1988; Schelling 1960; Tarar 2005) – or, that Greece could use its tumultuous domestic politics as leverage to reduce the severity of imposed austerity measures. The third is that international or 'Level 1' negotiators can employ various tactics to influence the domestic politics of their opponents in order to improve outcomes – the concept of 'reverberation' (Putnam 1988; Schoppa 1993) – in this case that German negotiators were able to shift public opinion within Greece in favor of Berlin's favored bailout agreement, and vice versa.

We distinguish our contribution in two ways. The first is in analytic description by seeking to identify – with greater precision than is found in the existing literature – the ideal points and win-sets brought by Greece and Germany to all three bailout negotiations. Doing so requires extensive sourcing, and we present most of this evidence systematically in a separate empirical appendix in the spirit of active citation (Moravcsik 2010). Second, this description facilitates the use of process tracing to test hypotheses regarding the sources of bargaining power. We find that the conventional view that the negotiated agreements predominantly reflected Germany's superior leverage (Schimmelfenning 2015) misses an important detail; on occasion, Greece was able to extract some minor but meaningful concessions representing departures from the German ideal-point. Importantly, such leverage came not via the successful signaling of domestic political constraints per the Schelling Conjecture, but because impartial technocratic experts credibly validated Greece's structural economic weakness. We conclude by discussing the theoretical and practical implications of these findings.

International debt crisis negotiations: theoretical framework

The continued integration of states' financial markets has increasingly meant that modern financial and debt crises have cross-border effects that constrain the policy options available to governments and require international cooperation to resolve (Cerny 1995). Fearon (1998) argues that international cooperation is characterized by a common strategic structure in which the negotiating parties must overcome two problems: a bargaining problem regarding the distribution of new or potential benefits, and an enforcement problem where monitoring and enforcement mechanisms may be needed to disincentivize defection from concluded agreements. While cooperation is contingent on each party gaining a minimum benefit (their 'reservation price'), the overall distribution of benefits is determined by relative bargaining power – primarily a function of the status quo costs in the absence of an agreement, or the best alternative to a negotiated agreement, BATNA (Raiffa 1982: 252–53; Zahariadis 2016a: 677).

Debt crises often deny their victims palatable outside options as the threat of default looms. Debtor governments are unable to access international financial markets at affordable interest rates to finance expenditures and meet debt obligations. Creditors as holders of sovereign debt face deteriorating balance sheets, in turn reducing the value of investments and creating systemic risk for interdependent economies (Lehman and McCoy 1992). The variation in outside options among parties is a form of asymmetric interdependence (Keohane and Nye 1977), in which the party enjoying superior alternatives can better withstand non-agreement and thus retains the bargaining advantage to win a relatively larger share of the payoffs from cooperation (Schimmelfenning 2015).[1]

Putnam (1988) drew attention to the fact that international bargaining is conditioned by domestic politics; negotiators are unwilling to enter agreements that would impose significant costs on domestic constituencies and thus threaten the government's political survival. Powerful domestic groups can prevent the domestic ratification of a concluded agreement they deem unfavorable to their interests (Iida 1993). Ratification constraints narrow the range of acceptable outcomes for government negotiators – their win-sets – and, as win-sets narrow, a mutually acceptable agreement becomes less likely. However, Putnam also theorized that domestic dynamics can be influenced by the actions of international negotiators themselves, a process he termed 'reverberation'. By deploying inducements or coercive threats, negotiators can reshape the policy preferences of domestic constituents and thus the win-sets facing opponent negotiators. Schoppa (1993) extended this logic, positing further mechanisms through which reverberation could operate, such as by expanding the size of the participating constituency, from elites to the mass public.

The two-level game can be readily extended to the dynamic between a government facing a sovereign debt crisis negotiating with its international creditors (Lehman and McCoy 1992). Debtor governments affected by declining asset prices and capital outflows are modeled as facing a tradeoff: shifting costs onto foreign investors ('creditors') through debt reductions ('haircuts'), currency devaluation, or outright default creates the risk of non-agreement and retaliation from creditors through protracted debt renegotiations, costly litigation by holdouts and the long-term exclusion from international financial markets, as was the case for Argentina following its 2001 default (Porzecanski 2005; Yue 2010). However, accepting the alternative of implementing harsh austerity policies to facilitate a debt accord inevitably reduces real output and employment and will anger workers and firms, igniting domestic opposition (Lehman and McCoy 1992). Creditors, which may be other governments, international financial institutions or banks, face a similar tradeoff: ask too much from the debtor and risk a no-agreement default and huge losses on existing investments, but ask too little and face retaliation from their own side, whether voters in the case of creditor governments, and members/shareholders in the case of international financial institutions and banks.

Where a debtor faces financial collapse, its (relatively) more secure creditors will enjoy a superior BATNA and should, therefore, capture a larger share of distributive gains. However, a strong domestic constraint, such as the ability of a legislature to vote down an agreement, could counter-intuitively increase the weaker side's bargaining power because it can allow a negotiator to argue that unfavorable terms would fail domestic ratification. Putnam took this insight from Thomas Schelling (1960), and subsequent research – both case studies and formal modeling – has explored the conditions under which such constraints – dubbed the 'Schelling Conjecture' – may affect bargaining power (Evans *et al*. 1993). No consensus has emerged; one vein of scholarship focuses on the distinction between complete and incomplete information (Milner and Rosendorff 1997; Tarar 2001), another disaggregates the domestic constituencies of the executive and legislature and allows the preferences of the respective groups to vary (Mo 1994; Tarar 2005). Clark *et al*. (2000) argue the Conjecture is necessary to understand the empirics of United States–European Union (EU) trade negotiations. In the specific domain of debt negotiations, Lehman and McCoy's (1992: 640–42) study of Brazilian debt negotiations in the 1980s found domestic weakness was a source of bargaining strength, improving the debtor's gains from the negotiated agreement.

We follow Schimmelfenning's (2015: 179) approach to studying the Eurozone crisis in drawing upon these theoretical perspectives to develop specific expectations, or hypotheses, to test against the empirical record. Where the evidence leads us to reject a hypothesis, our research design pivots from theory testing to heuristic theory development (George and Bennett 2005: 75) in which we utilize the evidence to identify new variables and/or causal mechanisms to assist with future theory development.

Hypothesis 1: Creditors will capture a disproportionately larger share of the benefits of cooperation because they can better withstand the costs of non-agreement.

Hypothesis 2: The credible domestic constraints signalled by the debtor will improve its share of the benefits of cooperation (the Schelling Conjecture).

Hypothesis 3: Negotiators' threats or inducements can 'reverberate' through the domestic politics of the opposing side, changing the prospects for agreement.

Case selection and research design

To simplify our analysis of the broad and complex series of debt negotiations conducted during the Eurozone crisis, we limit the scope of our inquiry to the most prominent subset: negotiations between Greece as debtor and Germany as the representative creditor. The case of Greece is arguably the most fertile ground for theory testing because the Greek government received three separate negotiated bailouts in 2010, 2012 and

2015, with the negotiations occurring in discrete and intensely scrutinized episodes bounded by externally imposed refinancing deadlines, with each set of negotiations yielding a cooperative agreement, thereby facilitating a comparison of each party's initial position with the negotiated outcome. Germany's leadership role within the Eurozone saw it widely cast as the representative creditor, with much scrutiny of the politics of the negotiations within Germany, and 'Germany vs. Greece' as the core media narrative. Accordingly, we consider this a 'crucial' case (George and Bennett 2005: 120) that established theories should aspire to explain.[2]

Our research design is structured as follows. For each bailout, we first seek to identify the ideal-point outcomes for each side and, to the extent possible, the parameters of their win-sets. We then inquire whether, how, and why the final agreement deviated from these initial objectives. Hypothesis 1 posits that negotiated outcomes would be far closer to the German ideal-point because the consequences of non-agreement for Greece were worse. Hypothesis 2 posits that Greece could leverage domestic political constraints to bring final outcomes closer to its ideal. Hypothesis 3 posits that negotiators' strategies could affect the final agreement via their impact on the opponent's domestic politics. Our methodology is qualitative, relying on a particular type of process tracing that George and Bennett term 'analytic explanation', seeking to convert a historical narrative into an analytical causal explanation and facilitate hypothesis testing (George and Bennett 2005: 211; Kourtikakis 2010: 28). The hypotheses do not offer an exhaustive list of causal factors; where the evidence points to rejection of a hypothesis, our case study methodology pivots to the heuristic theory-building purpose.

We rely on publicly available resources, such as speeches, media interviews and media reporting. Importantly, the hypothesis testing process necessitates reliance on *contestable empirical evidence*, insofar as we draw inferences and make judgments regarding the initial negotiating positions of the parties and the reasons why a concluded outcome (the only category of truly observable fact) differed from any initial position. To maximize transparency and facilitate robust and critical scrutiny of these inherently uncertain judgments (especially should new evidence become available), as well as the replicability of our findings in the spirit of active citation (Moravcsik 2010, 2014), accompanying this paper is an online appendix in which we set out our empirical conclusions – organized consistently with our theoretical framework – referenced extensively by the sources relied upon to draw those conclusions. Such depth would be infeasible within the confines of the paper itself, which moreover frees us to omit most referencing from our analytical narrative below, other than to source arguably some of the most contested and interesting factual points.

Sources of bargaining power in Eurozone debt crisis negotiations

The first bailout of Greece: heavy concessions from both sides in the face of collapse and contagion

In the beginning of 2010, the Greek government found itself in a perfect storm surrounding the sustainability of government finances and, at first, it could do no more than deny the severity of the situation. Following an upward revision of the budget deficit for 2009 to 12.7 percent, Prime Minister George Papandreou's newly elected government announced an extensive package of austerity measures to appease financial markets. At the same time, government officials denied the need for a special bailout agreement with European partners and insisted on accessing private markets even a few days before such agreement was finalized in late April 2010. The ideal outcome for Greece would be a commitment by its Eurozone partners to provide financial help if needed, with a minimum of politically unpalatable austerity measures. Once Greek access to the private markets was blocked, the government's ideal position shifted gradually towards an organized restructuring or lessening of the Greek debt, but rumors of such shift upset the stocks of Greek banks and were not made public. It quickly became clear that the low-end boundary of the Greek win-set was determined by the enormous costs of a potential default and exit from the Eurozone. 'Anything but Grexit' would become a recurring theme in the speeches of the numerous Greek Prime Ministers and Ministers of Finance during the following five years.

German officials, representing Greece's creditors, were extremely reluctant to commit to a financial assistance mechanism in early 2010. Following revelations that the Greek government used logistical manipulations to hide budget deficits, German domestic opinion was against participation in any assistance program and even favored letting Greece exit the Eurozone. Did a Greek default and potential exit from the Eurozone feature as the lower bound of the German win-set in early 2010? Although a number of MPs from the governing coalition (namely, the Bavarian Christian Union and the Free Democratic Party) expressed views to that effect, and Chancellor Angela Merkel herself cast doubt on the decision to accept Greece into the Eurozone in the first place, on balance it was never considered a serious possibility by senior German officials. Germany also opposed an official recognition of the lack of sustainability of Greek refinancing for fear that this unprecedented admission would induce debt contagion in other Eurozone countries. Non-committal language by German leaders as late as March 2010 shows that, although secret plans already existed for a publicly funded bailout, their ideal preference point for resolving the crisis involved imposing austerity upon

Greece without using funds from German public coffers for international loans, but instead turning to multilateral institutions to address the problem.[3]

Greece did eventually receive extensive financial help in 2010, amounting to €110 billion and agreed to rigorous fiscal adjustment, lowering government spending, pension reform and a range of other difficult austerity measures. It was not, however, granted any debt restructuring despite the recommendations of many economists and reservations of non-European International Monetary Fund (IMF) executive-board members about the feasibility of the program's targets (Economides and Smith 2011; *Wall Street Journal* 2013). The IMF played second fiddle in its arrangement with the European Commission and the European Central Bank, and these concerns were not reflected in the joint position taken by this 'Troika'. The austerity measures were deemed even harsher than the ones already implemented by the Papandreou government leading up to the bailout negotiations. The logic of the 'Memorandum of Understanding' between Greece and its creditors instructed an early, front-loaded deficit reduction with negative effects on the country's GDP in hope of a swift turnaround. Violent riots erupted in Greek cities, notably in front of the Parliament building. The polling percentages of PASOK, the dominant political party in Greece for four decades, would never recover from the electoral shock of the implementation period of the first Memorandum.

Germany, like Greece, also had to make large concessions and depart from its ideal preference point because of the risks for German and other European institutions and the uncertainty over contagion effects to other Eurozone countries that had already begun to manifest. The German parliament approved participation in the financing facility (EFSF) that provided emergency financing to Greece and other Eurozone members. Germany was overwhelmingly the largest contributor and the unpopularity of the program was reported to contribute to the resounding defeat of the ruling Christian Democratic Union in the Nord Rhein-Westphalia regional elections a few days later. Schneider and Slantchev (2018: 24) note that the timing of Germany's pivot towards an agreement in late April and early May put Merkel in an 'inherently weak' domestic position even though she did not extend substantive concessions to Greece. Merkel and Finance Minister Wolfgang Schäuble were forced to concede on the timing considering the danger of contagion to private financial institutions and other Eurozone states, a danger reflected in the depreciating Euro and the increasing bond yields for other members. The tone struck by Schäuble in his Bundestag speech before the vote is indicative of the sense of concessions made: 'Any other alternative would be much more expensive for the German state, it would be much more dangerous, it would take up many more risks' (Wearden 2010).[4]

Accordingly, our conclusion is that Greece and its creditors settled for a necessary but costly deal. The distribution of costs weighed more heavily on Greece, the side threatened by imminent collapse; however, the uncertainty that lay in a potential Greek default for German financial institutions and the Euro as a whole meant that the final outcome differed significantly from the German government's ideal. Overall, domestic politics in the form of upcoming elections, opinion polls and large-scale demonstrations did not provide leverage to Greece, because potentially large electoral losses did not act as credible constraints. Contagion, uncertainty and unity of the common currency, that is, the consequences of high levels of interdependence were in the minds of everyone. Public statements by Greek and German leaders were aimed at 'speculators' rather than the actions of national governments and thus there is little evidence of reverberation attempts at this point. One possible exception was the claim by the Greek Deputy Prime Minister that Germany was profiting from the crisis and that Germany owed war reparations, but these comments did not attract significant attention in Germany. The reparations issue would, however, feature more prominently in negotiations between the parties that led to the 2015 bailout.

The second bailout of Greece: credit-rating agencies and erroneous performance projections soften Greek concessions

Throughout 2011 it became increasingly clear that Greece would need a second bailout package, a likelihood portended in particular by the downgrading of Greek government bonds to near-junk status in the first half of 2011 by international credit-rating agencies. The Greek economy was underperforming – albeit with disagreement regarding whether this was due to the burden imposed by austerity, or because austerity was being insufficiently implemented – and the projections of EU and IMF officials for Greek growth were quickly becoming unrealistic. Thus even before the novelty of bailing out a Eurozone country had worn off, European officials were faced with increasing rumors of a disorderly default with huge losses for Greek and international banks. The Greek win-set was, once again, delimited by the scenario of this default and a possible exit from the Eurozone, which remained Athens' worst-case scenario (Erlanger 2011). The ideal outcome of the second negotiations, however, included a number of new dimensions, besides the extent of austerity measures. The Greek ideal position combined a change in repayment terms of the original bailout, a 'haircut' accepted by all bondholders with special protections for Greek banks to cushion the effects of the nominal losses, a mutualization of European debt and a less onerous austerity package. The self-fulfilling dynamic of public statements during the extended period of negotiations and the heavy domestic opposition forced Greek negotiators to camouflage their preferences, but the published memoires of the two Greek Finance Ministers of that period, George Papaconstantinou and Evangelos Venizelos, confirm the above as the main objectives of the Greek negotiating team during that period (Papaconstantinou 2016: 194–95; Venizelos 2017: 5–6).

The German Finance Minister, Wolfgang Schäuble, recognized the need for a new program as early as February 2011, therefore the German government's win-set during the second bailout negotiations did not include a threat to abandon negotiations or to force Greece out of an agreement. The ideal preference point of the German government coalition, which included the more hostile minor partner, the Free Democrats, became clearer by mid-2011; it comprised more austerity for Greece and no changes in the terms of the 2010 bailout agreement, but recognized the need to distribute the costs of a new bailout more widely, through a combination of public- and private-sector involvement. Comparing the two ideal-point preferences, one could argue that the two countries were at their closest during this period, as they both agreed largely on the need for extensive private-sector involvement. However, as their respective publics grew increasingly hostile to the conditions of the bailout agreements, the tone of negotiations was significantly more combative despite the closeness of the two sides' negotiating positions.

The negotiated outcome was nevertheless closer to the German position. There was a large, voluntary 'haircut' sustained by private-sector partners in the agreement through a bond rollover – at 53.5 percent, the largest of such kind in the history of financial crises – and no equivalent nominal haircut for government-backed loans. Perhaps as importantly, the Greek government agreed to impose further painful austerity measures, including a significant minimum wage reduction, pension cuts and a substantial decrease in public sector employees. Greek opposition parties rightly predicted that the imposed debt restructuring would negatively affect the balance sheets of already strained domestic banks and pension funds. But creditors, including Germany, made a number of concessions to Greece that fell outside their initial win-set. In a marathon summit in July 2011, Greece secured an additional €130 billion of financial assistance, and moreover a retroactive reduction in the interest rates attached to the first bailout loans, the grant of a 10-year grace period before loan repayment, and provisions for the repayment to the Greek government of any income accruing to European central banks from Greek government bonds held in their investment portfolios. In addition, the international press at the time estimated that the imposed austerity measures fell short of that sought by the more 'hawkish' elements in Angela Merkel's coalition government. Thus an evaluation of the distribution of payoffs reveals that the deal was definitely closer to the German than Greek ideal position, especially with regard to continuing austerity; however, Greece's aforementioned gains should not be underestimated.

What can account for such comparatively minor but quite real gains? It was surely not any kind of domestic political leverage; indeed, the new austerity measures forced Greek PM George Papandreou to resign from his post in November 2011, following his gamble to announce a referendum on the deal – a referendum humiliatingly called off after Angela Merkel and French President Nicolas Sarkozy announced that the referendum could not be about the acceptance of further austerity measures, but would rather decide the continuation of Greece in the Eurozone. The prospect of upcoming Greek elections or defections of MPs was factored by creditors into negotiations mainly as a potentially costly delay of inevitable measures (Wearden 2012). There is also, not unlike before the first bailout, little evidence of reverberation – Greek Prime Minister George Papandreou only visited Berlin in late-2011, after the bailout agreement had been agreed upon, although the positive reception by the German press seemed to have eased the way towards an acceptance of further financial aid towards Greece.

Ultimately, the concessions made to Greece, especially in the form of improved terms on existing loans and the private-sector 'haircut', were granted only when it became clear that Greece's debt burden was simply unsustainable. Importantly, these conclusions were founded upon the credible information provided both by private credit-rating agencies and the IMF. The first half of 2011 saw the ratings agencies furnish downward performance projections of the Greek economy and statements that Greek debt was unsustainable. On 7 March, for example, Moody's downgraded the creditworthiness of Greek state bonds by three degrees with negative outlook and five days later, the European creditors agreed to lower interest rates of Greek loans by 1 percent and to extend the repayment period to 7.5 years. In the first half of June, Moody's and Standard and Poor's downgraded the Greek bonds further to the C-category, approaching 'junk' status, which brought about the direct concessions of the July summit (lower interest rates, extended grace periods) detailed above. The two rating agencies cited the overly ambitious goals set by the program for Greece and the poor record of the Greek state in achieving tax-collecting goals as the main reasons behind their decisions. Greek Finance Minister Papaconstantinou confirms in his memoire that the reactions of the rating agencies prohibited further delays:

> The informal Eurogroup and ECOFIN meetings convened on June 14th, one day after S & P cut Greece's sovereign credit rating to CCC, the lowest grade for any country it reviewed in the world … we were clearly running out of time and decisions would have to be taken at the formal Eurogroup scheduled for June 20th [2011]. (Papaconstantinou 2016: 209)

Official Greek statistics, when not downright unreliable, repeatedly underscored the worse-than-expected performance of tax receipts and the persistent negative spiral of economic activity (Tagesschau 2011). The IMF, despite reeling from the dramatic resignation of Managing Director Dominique Strauss-Kahn in May, nevertheless added to the credibility of these claims, reporting in July on the 'heroic assumptions' underlying debt-sustainability projections. Thus creditors were faced with a very real prospect of disorderly default – a costlier outcome than keeping Greece afloat – but the evidence of that came not from signals sent by Greek government or looming elections, but the highlighting by non-governmental credit-rating agencies of structural economic realities.

The third bailout of Greece: the IMF softens Greek capitulation

The third round of bailout negotiations took place in the first half of 2015 and culminated in a standoff in June–July. The situation became so grave that it prompted European Council President Donald Tusk to speak of the 'most critical five days in the history of the European Union' and Commission President Jean-Claude Juncker to reveal a Commission plan for humanitarian assistance to Greece in the event of a Grexit. In January 2015 a radical-left party, SYRIZA, won national elections, and promptly formed a vehemently anti-austerity coalition government with a small right-wing populist party, Independent Greeks, promising to radically renegotiate agreements with creditors. Over the next six months, the Greek government and its creditors reached what seemed to be a genuine impasse, with both sides delaying procedures and no side showing willingness to make any meaningful concessions on crucial aspects of the program.

One should not underestimate the initial differences between the two sides, but nor should one ignore the convergence achieved before the final July agreement. SYRIZA came to power promising wage and pension increases, tax repeals, a renegotiation of the onerous primary surpluses imposed on Greece by previous agreements and some debt relief, but it is more realistic to determine the party's win-set and ideal position from an interim agreement they made with the country's creditors in February 2015. At the time, the new Greek government successfully extended the existing financial assistance program and backpedaled on many electoral promises with regard to pensions, public sector wages and privatizations, but neither the agreed statement nor Greek government ministers addressed various important issues regarding fiscal consolidation. The Greek government's ideal position, based on statements of the responsible ministers during the period prior to the January elections, probably included the elimination of primary surpluses as a condition for financial assistance, the curtailment of planned privatizations, a renegotiation of pension system reforms and exceptional spending on the country's 'humanitarian crisis'. There is considerable debate on whether a unilateral default and exit from the Eurozone was included in the win-set of the new Greek government. Although never admitted officially, the possibility of a parallel monetary system of IOUs was processed by a secret unit of the Ministry of Finance.[5] Greek Prime Minister Alexis Tsipras later admitted in a closed session of the parliamentary group what his predecessors had stated publicly, namely that an exit from the Eurozone ran the risk of 'an explosion of the state apparatus', essentially further limiting the set of possible options for the Greek government (Kathimerini 2015).

On the other hand, the German position, notwithstanding a well-documented rift between Chancellor Merkel and the ever-dismissive Finance Minister Wolfgang Schäuble, remained essentially steadfast: not much change from the 2012 agreement could be achieved in areas such as fiscal targets, pension system cuts, privatizations and labor market reforms. In fact, the German position hardened progressively (in the sense of rhetorically expanding the acceptable costs of non-cooperation) with several MPs re-igniting the idea that Greece should be assisted to leave the Eurozone. The final days of negotiations in late June, featured dramatic developments despite an earlier convergence towards a proposal of the Commission President Jean-Claude Juncker. Tsipras broke the negotiation deadlock by calling a referendum on the Juncker proposal and campaigning against it. Greek banks closed for several days and capital controls were imposed, and Greece failed to make a payment to the IMF, the first OECD country ever to do so. A resounding 'No' in the referendum led German and Commission officials to prepare for a unilateral default and exit of the country from the Eurozone, with the German Finance Minister explicitly putting a Grexit plan on the table. In the end, however, Tsipras succumbed to a third bailout agreement in what has been widely regarded as a total capitulation. The Greek government agreed to a new bailout agreement until 2018, which extended commitments to long-term fiscal surpluses, created a privatization fund co-managed by the Greek government and its creditors and established an automatic fiscal readjustment mechanism.

The distance between ideal and final outcomes was larger for Greece and smaller for Germany compared to the previous two bailouts. In the intervening three years since the last bailout the costs of defection had remained prohibitively high for Greece and included the sunk costs of five years of austerity, but had decreased for Germany: German financial institutions had already absorbed the costs of the 2012 'haircut' and the rest of the Eurozone was shielded by better growth prospects and the monetary operations of the European Central Bank. However, it would again be incorrect to assume that creditors made no concessions to Greece whatsoever. Primary surplus targets were revised downwards for 2015–2017 and only in 2018 did the new package require a return to primary surpluses of 3.5 percent. Commission President Juncker pledged €35 billion of various investment funds from the EU budget to be used in various public- and private-sector initiatives until 2020. Perhaps most importantly, the IMF widely publicized a report revealing heretofore-concealed skepticism towards the sustainability of the Greek debt both in the buildup and the aftermath of the negotiations.

Greece's comparatively erratic movement from an ideal position to the final deal can again be explained with reference to the catastrophic consequences of a failure to agree. Greece gave some ground early in 2015 but in March neither Greece nor Germany felt they could make further concessions. Bellicose negotiating tactics by Tsipras and Finance Minister Yanis Varoufakis, including repeatedly raising the issue of German war reparations, only served to worsen relations with creditors. Yet a failure to return to the table and reach agreement by July would cause disorderly default. Ultimately, Tsipras was forced to break with his coalition and return with concessions to the negotiating table in May, where the cycle then repeated. Tsipras again broke from his coalition and returned to the negotiating table with five ‘red lines’ – areas where he would refuse to accept austerity. Yet creditors would not accept Tsipras’s red lines, and Greece’s intransigence failed to elicit further concessions. In July, Tsipras had no choice but to return with an offer of decreased pensions and increased VAT that was again rejected as insufficient. As above, Tsipras responded with a referendum that rejected the creditors’ proposals but succeeded only in upsetting creditors. All else having failed, it appears Greece’s Prime Minister ultimately agreed to creditors’ demands because the consequences of doing otherwise were so severe. Hence a clear pattern emerged in 2015 where unsuccessful Greek intransigence was followed by unsuccessful, provocative negotiating tactics and the ‘illusion of control’ (Zahariadis 2016b: 488), leaving Greece no choice but to offer concessions in line with creditor demands or accept the catastrophic consequences of non-agreement.

Although Greece was unable to pressure creditors into making concessions with intransigence, concessions followed when it was clear that Greek structural issues rendered creditors’ positions unworkable. Already in May, IMF officials threatened to walk out of negotiations if European creditors did not agree to write off part of the country’s accumulated long-term debt. The IMF Chief Economist reiterated this position in a much-publicized blog post addressed to the public two weeks before negotiations collapsed (Blanchard 2015; Spiegel and Donnan 2015). IMF pressure, including official debt-sustainability analyses, later led in December 2016 to agreements on short-term debt relief measures, although these did not completely allay the Fund’s concerns. The statutory obligation of the IMF to participate in financial assistance programs only if the debt of the assisted countries is considered sustainable, as well as the reluctance of non-European countries to resume contributions to a comparatively wealthy European country, essentially forced Germany and other European creditors to act on non-private debt relief.

Much like the previous two bailout agreements, domestic political exigencies did not seriously affect the substance of concessions made by the two sides. In the case of Greece, this could not be more spectacularly demonstrated than by Tsipras’ volte-face following a resounding popular rejection of austerity in the Greek referendum. In the German case, the political imperative to keep the IMF in the Greek bailout program[6] eventually forced the German government to make concessions and did not serve as a credible commitment to hold an intransigent position. The final, cooperative outcome seems unremarkable, indeed trivial to explain: an agreement was always less costly than the alternatives for both parties.

Again, however, the puzzle arises from a less lopsided distribution of payoffs than widely believed. Ultimately, Greece secured some important gains and, as Donald Tusk later described, at the final summit both sides asked to leave the negotiating table over a mere 2.5 billion in an 'authentic reaction … as both were absolutely sure that they had compromised too much'. There is very little evidence for the positive effects of reverberation – of Greek leaders directly trying to influence German public opinion. Although Tsipras' March 2015 Berlin visit left a good impression and eased negotiations, Varoufakis' public comments in June (most notably comparing Greece to the Weimar Republic before a German audience) were regarded as counter-productive. A more important change from the second bailout was that international credit-rating agencies did not play an important role in signaling that the Greeks had reached their limits, because prices of Greek bonds had not regained their status as credible signaling mechanisms. Where did the credible signal that Greece could not bear higher costs come from? As already explained, debt-sustainability analyses provided by the IMF (and corroborated, to some extent, by European Commission officials) impelled Germany and other European creditors to provide concessions to Greece, absent the fears of contagion and any credible signals from financial markets that a default was imminent. The leaked minutes of an internal IMF teleconference between Poul Thomsen, the head of the IMF's European Department, and Delia Velculescu, the IMF Mission Chief for Greece, reveal the renewed role of the IMF as the carrier of credible signals for concessions to European creditors:

> Thomsen: 'I am not going accept a package of small measures. I am not … ' said Thomsen. 'What is going to bring it all to a decision point? In the past there has been only one time when the decision has been made and then that was when the Greeks were about to run out of money seriously and to default. … And possibly this is what is going to happen again.' …
>
> Velculescu: … the Germans raise the issue of the management … and basically we at that time say 'Look, you Mrs. Merkel you face a question, you have to think about what is more costly: to go ahead without the IMF, would the Bundestag say "The IMF is not on board"? or to pick the debt relief that we think that Greece needs in order to keep us on board?' Right? That is really the issue. (*To Vima* 2016)

Conclusion

Despite its status as one of the most important and potentially consequential events in world politics in the twenty-first century, the outcomes of the Eurozone crisis – and in particular the Greek bailout negotiations – are not especially puzzling to students of cooperation theory. Yet even the simple narrative – that the parties preferred costly bailouts to the prospect of dealing a fatal blow to the monetary union, but that the weaker Greece consistently received the worst from the bargained agreements – is deserving of thorough scrutiny, not least because embodied in such conclusions are factual assumptions regarding the parties' win-sets and the factors determining the distribution of benefits from cooperation. In this paper, we sought to test three basic hypotheses on bargaining amid financial crisis, and in doing so compiled a detailed appendix of qualitative empirical evidence from three Greek bailout negotiations in 2010, 2012 and 2015, which we use to justify factual conclusions that nevertheless remain contestable.

Our empirical analysis largely conforms to the predictions of established scholarship on financial crisis bargaining. The party that had more to lose from non-cooperation and the continuation of the status quo (Greece) departed from its ideal position more significantly than the party that could wait out the negotiations (European creditors, represented by Germany). However, we show that the negotiated agreements also reflected meaningful concessions to Greece despite initial opposition – namely various forms of partial debt relief – and such outcomes appear to lend support to the Schelling Conjecture that bargaining strength can be derived from domestic constraint.

Our most novel finding is however that such constraints were sourced neither in domestic politics nor reverberation. Pivoting from theory testing to heuristic theory development, we highlight the importance of the debtor's structural economic weakness: a credible signal crystallized that Greece could not bear the costs of further fiscal consolidation. A credible threat of unilateral default arose not when Greek politicians resigned, or called early elections or referenda, but when the inability of the Greek state to meet projected targets became clear. This signal came not from the debtor government, but international actors. In 2012 this role was led by international credit-rating agencies drawing from reporting by national and European statistical agencies on the gross underperformance of the Greek economy, with the IMF following with similar conclusions. During the 2015 negotiations, the IMF performed this function, giving impartial credibility to the signal that Greece's economic weakness limited the scope for continued austerity, and the resulting need to renegotiate the terms of the bailout agreements further in Greece's favor.

These findings carry an important policy implication: the credibility of the weaker side's signal is affected not by domestic political actors, but by the technocratic assessments of third parties like the IMF and international credit-rating agencies. The Greek financial crisis reveals that debtor governments may be more likely to gain concessions if they engage with such actors to establish the material non-viability of austerity programs, rather than deploying domestic political constraints, such as elections or upcoming parliamentary votes. The crisis also demonstrates how credible information from third parties can influence debt negotiations – suggesting that while organizations like the IMF enjoy legitimacy and credibility as sources of impartial expertise, they will retain significant influence in major episodes of global financial instability.

Notes

1. Successful debt crisis negotiations do not yield positive payoffs; both sides must *pay costs* in a cooperative outcome. Preventing contagion requires creditors to finance costly bailouts and debt forgiveness. Debtors avoid financial collapse, but must accept painful austerity measures. Such costs are still less than the catastrophic risks of non-agreement, such as debtor default, large investment losses and contagion for creditors, and second-order effects like a currency union collapse.
2. It also requires sensitivity in the empirical analysis to the possibility that departures from the German position were a function of intra-creditor bargaining – which indeed was the case at least once vis-à-vis the IMF in 2015.
3. Germany's stated interests were 'negotiating in the European interest, and demonstrating our commitment to Europe in defending the stability of the euro'. A mechanism must 'be triggered only once Greece had exhausted its capacity to raise money on the international capital markets': Peel *et al.* (2010).
4. Also see, Wolfgang Schaeuble's (2010) speech before German Parliament.
5. The then Finance Minister later confirmed the existence of a contingency plan in the event negotiations faltered (see official statement at https://yanisvaroufakis.eu/2015/07/27/statement-by-yanis-varoufakis-on-the-finmins-plan-b-working-group-the-parallel-payment-system/) and backed by his then advisor James K. Galbraith.
6. Throughout, Berlin has insisted on IMF support because bailouts are politically more acceptable in Germany if seen as an international undertaking.

Disclosure statement

No potential conflict of interest was reported by the authors.

Notes on contributors

Darren J. Lim is a lecturer in the School of Politics and International Relations at the Australian National University.

Michalis Moutselos is a research fellow at the Max Planck Institute for the Study of Religious and Ethnic Diversity.

Michael McKenna is a researcher in the School of Politics and International Relations and a student in the Master of Computing program in the College of Engineering and Computer Science at the Australian National University.

ORCID

Darren J. Lim http://orcid.org/0000-0003-1565-8510
Michalis Moutselos http://orcid.org/0000-0002-8454-1124
Michael McKenna http://orcid.org/0000-0002-8124-591X

References

Blanchard, O. (2015) 'Greece: a credible deal will require difficult decisions by all sides', *IMF Blog*, 14 June, available at https://blog-imfdirect.imf.org/2015/06/14/

greece-a-credible-deal-will-require-difficult-decisions-by-all-sides/ (accessed 11 November 2016).
Cerny, P.G. (1995) 'Globalization and the changing logic of collective action', *International Organization* 49(4): 595–625.
Clark, W.R., Duchesne, E. and Meunier, S. (2000) 'Domestic and international asymmetries in United States–European Union trade negotiations', *International Negotiation* 5(1): 69–95.
Economides, N. and Smith, R. (2011) 'How should a Greek debt restructuring be done and what are its consequences', *Kathimerini*, 8 May, available at http://www.stern.nyu.edu/networks/How_Should_a_Greek_Debt_Restructuring_Be_Done_and_What_Are_Its_Consequences_05082011.pdf (accessed 5 July 2016).
Erlanger, S. (2011) 'Greek threat to quit euro is labeled a false report; Prime minister denies plans to restructure debt as crisis deepens', *International Herald Tribune*, 9 May.
Evans, P.B., Jacobson, H.K. and Putnam, R.D. (eds) (1993) *Double-edged Diplomacy: International Bargaining and Domestic Politics*, Berkeley: University of California Press.
Fearon, J. (1998) 'Bargaining, enforcement, and international cooperation', *International Organization* 52(2): 269–305.
George, A. and Bennett, A. (2005) *Case Studies and Theory Development in the Social Sciences*, Cambridge, MA: MIT Press.
Hennessy, A. (2017) 'Good samaritans vs. hardliners: the role of credible signalling in Greek bailout negotiations', *Journal of Common Market Studies* 55(4): 744–61.
Iida, K. (1993) 'When and how do domestic constraints matter? Two-level games with uncertainty', *Journal of Conflict Resolution* 37: 403–26.
Kathimerini, I. (2015) 'Tsipras: Iparchi kindynos anatinaksis toy Kratoys' ('Tsipras: There is a danger that the state apparatus might explode') 11 July, available at http://www.kathimerini.gr/823063/article/epikairothta/politikh/tsipras-yparxei-kindynos--anatina3hs-toy-kratoys (accessed 10 November 2016).
Keohane, R.O and Nye, J.K. (1977) *Power and Interdependence: World Politics in Transition*, Boston, MA: Little, Brown.
Kourtikakis, K. (2010) 'Imitation and supranational politics: some lessons from the European Ombudsman and the European Court of Auditors', *European Political Science Review* 2(1): 27–48.
Lehman, H. and McCoy, J. (1992) 'The dynamics of the two-level bargaining game', *World Politics* 44: 600–44.
Matthijs, M. (2016) 'Powerful rules governing the Euro: the perverse logic of German ideas', *Journal of European Public Policy* 23(3): 375–91.
Milner H.V. and Rosendorff, B.P. (1997) 'Democratic politics and international trade negotiations: elections and divided government as constraints on trade liberalization', *Journal of Conflict Resolution* 41: 117–46.
Mo, J. (1994) 'The logic of two-level games with endogenous domestic coalitions', *Journal of Conflict Resolution* 38: 402–22.
Moravcsik, A. (2010) 'Active citation: a precondition for replicable qualitative research', *PS: Political Science and Politics* 43: 29–35
Moravcsik, A. (2014) 'Transparency: the revolution in qualitative research', *PS: Political Science and Politics* 47(1): 48–53.
Papaconstantinou, G. (2016) *Game Over: The Inside Story of the Greek Crisis*, Athens: CreateSpace Independent Publishing Platform.
Peel, Q., Hall, B. and Chaffin, J. (2010) 'Germany sets conditions for Greece', *Financial Times*, 23 March.

Pitsoulis, A. and Schwuchow, S.C. (2017) 'Holding out for a better deal: brinkmanship in the Greek bailout negotiations', *European Journal of Political Economy* 48: 40–53.
Porzecanski, A. (2005) 'From rogue creditors to rogue debtors: implications of Argentina's default', *Chicago Journal of International Law* 6: 311–32.
Putnam, R.D. (1988) 'Diplomacy and domestic politics: the logic of two-level games', *International Organization* 42(3): 427–60.
Raiffa, H. (1982) *The Art and Science of Negotiation*, Cambridge, MA: Harvard University Press.
Schaeuble, Wolfgang. (2010) 'Rede zum Währungsunion Finanzstabilitätsgesetz' ('Speech concerning law for currency union and financial stability'), available at http://www.bundesfinanzministerium.de/Content/DE/Reden/2010/2010-05-07-waehrungsunion-finanzstabilitaetsgesetz.html (accessed 25 May 2017).
Schelling, T.C. (1960) *The Strategy of Conflict*, Cambridge, MA: Harvard University Press.
Schimmelfenning, F. (2015) 'Liberal intergovernmentalism and the euro area crisis', *Journal of European Public Policy* 22(2): 177–95.
Schneider, C.J. and Slantchev, B.L. (2018) 'The domestic politics of international cooperation: Germany and the European debt crisis', *International Organization* 72 (1): 1–31.
Schoppa L.J. (1993) 'Two-level games and bargaining outcomes: why Gaiatsu succeeds in Japan in some cases but not others', *International Organization* 47: 353–86.
Spiegel, P. and Donnan, S. (2015) 'IMF criticises Greek bailout deal with EU', *Financial Times*, 15 July.
Tagesschau. (2011) 'Griechische Staatsschulden "außer Kontrolle"' ('Greek public debt "out of control"'), 1 September, available at http://www.tagesschau.de/wirtschaft/griechenland1430.html (accessed 8 February 2017).
Tarar, A. (2001) 'International bargaining with two-sided domestic constraints', *Journal of Conflict Resolution* 45(3): 320–40.
Tarar, A. (2005) 'Constituencies and preferences in international Bargaining', *Journal of Conflict Resolution* 49(3): 383–407.
To Vima. (2016) 'Wikileaks reveals Thomsen-Velculescu talks on Greek review', 2 April, available at http://www.tovima.gr/en/article/?aid=789620 (accessed 8 February 2017).
Tsebelis, G. (2016) 'Lessons from the Greek crisis', *Journal of European Public Policy* 23 (1): 25–41.
Venizelos, E. (2017) *Mithoi kai Alithies gia to Dimosio Chreos 2012–2017*. Myths and Truths Regarding the Public Debt. 2012–2017 Athens: Epikentro.
Wall Street Journal (2013) 'IMF document excerpts: disagreements revealed', *Real Time Economics Blog*, 13 October, available at http://blogs.wsj.com/economics/2013/10/07/imf-document-excerpts-disagreements-revealed/ (accessed 25 May 2017).
Wearden, G. (2010) 'Europe's financial crisis: as it happened', *The Guardian,* 28 April.
Wearden, G. (2012) 'Eurozone crisis live: deal reached on Greece after all-night talks', *The Guardian*, 20 February.
Yue, V. (2010) 'Sovereign default and debt renegotiation', *Journal of International Economics* 80(2): 176–87.
Zahariadis, N. (2016a) 'Bargaining power and negotiation strategy: examining the Greek bailouts, 2010–2015', *Journal of European Public Policy* 24(5): 675–94.
Zahariadis, N. (2016b) 'Values as barriers to compromise? Ideology, transnational coalitions, and distributive bargaining in negotiations over the third Greek bailout', *International Negotiation* 21: 473–94.