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What if Greece got massive debt relief but no one admitted it? (Part 1.5)

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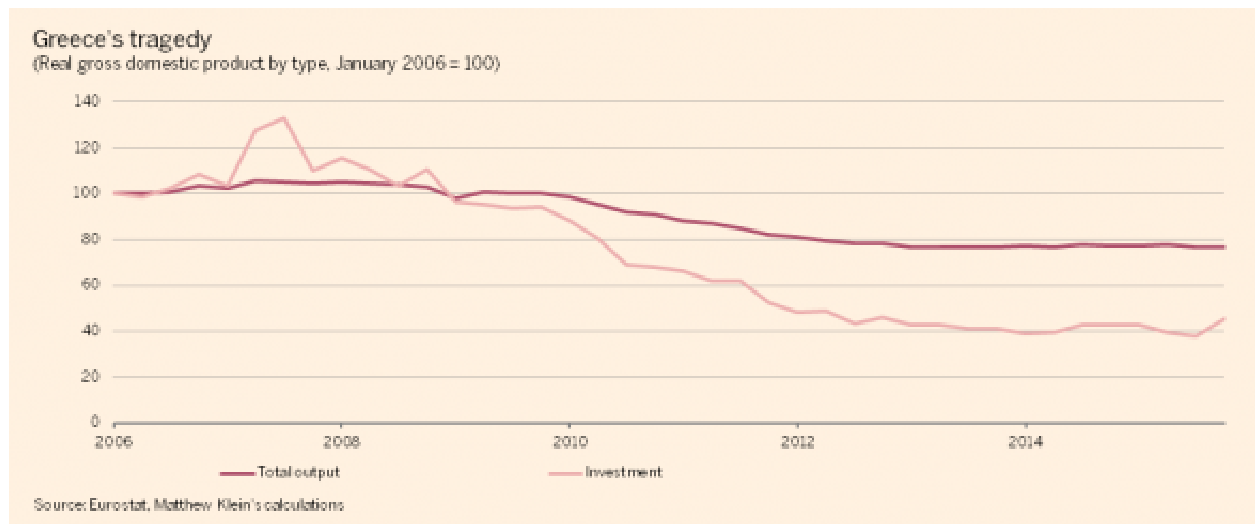
After years of failed attempts to stabilise the Greek economy, the Greek government finally got debt relief in 2012. As we explained in our previous post, interest payments fell by more than half between 2011 and 2013. Since the 2012 modifications, Greece's sovereign debt service costs have been significantly smaller as a share of total output than in Italy or Portugal.

Yet it hasn't helped much. The economy continues to contract and Greece's depression since 2008 is among the absolute worst of any country in the world since 1980. Investment spending had already plunged by 60 per cent in real terms between the peak in 2007 and the end of 2011. Since then, it's dropped another 13 per cent. Overall, Greece has had *no* economic growth since the beginning of 2013:

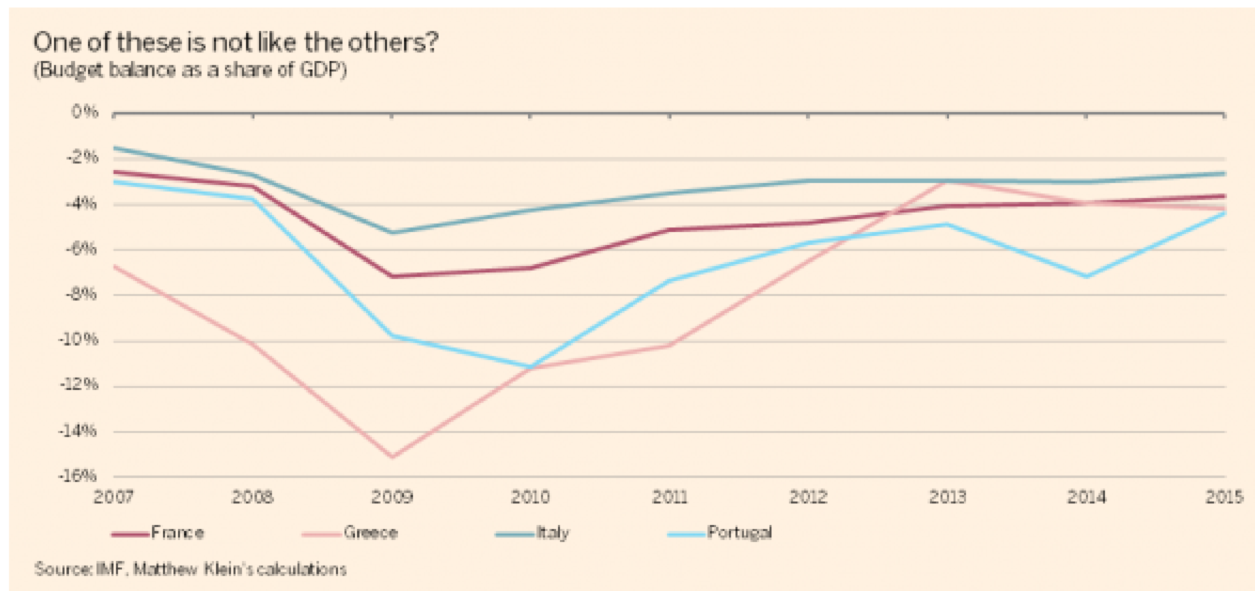


Part of the reason: the debt modifications failed to convince private investors to return to Greece, despite having "solved" the problem of government debt service costs.

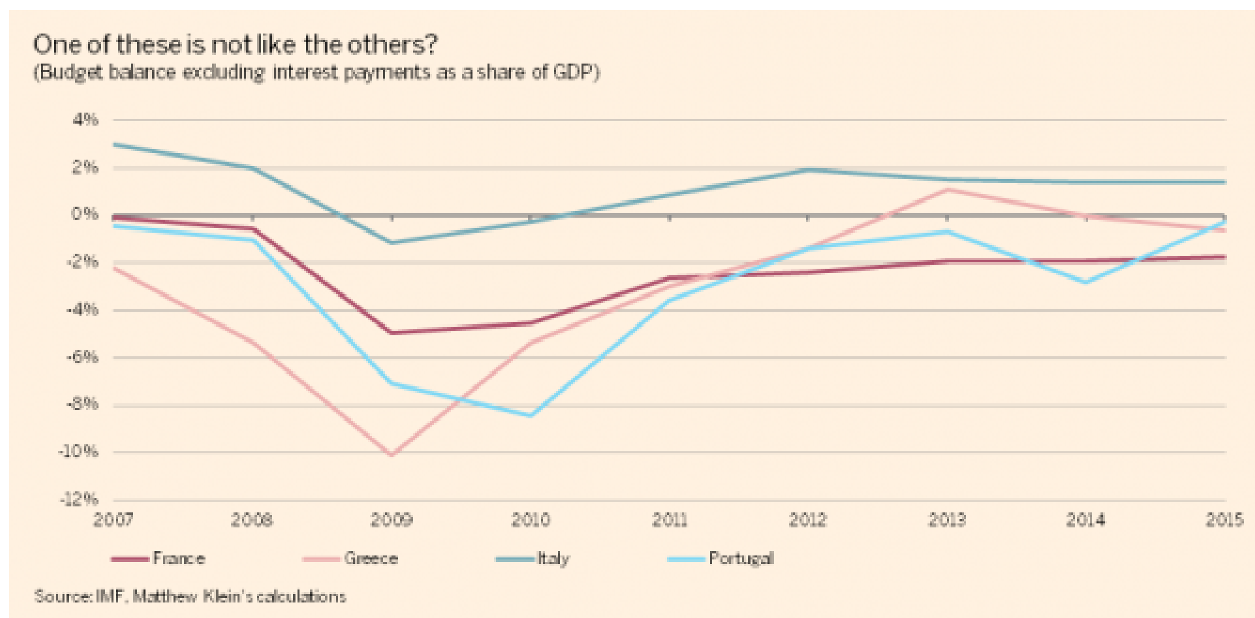
No private investors — and no monetary sovereignty — means the Greek government must beg "official sector" creditors to fund its deficit, and those lenders have historically made damaging demands for tax hikes and spending cuts. As if that weren't bad enough, being forced to negotiate every time the country needs to roll over maturing debt often leads to crises. The result is constant uncertainty, punishingly high capital costs, low asset prices, and mass

unemployment.

The irony is Greece's sovereign net borrowing needs are quite low, at least relative to many other euro area countries. According to the International Monetary Fund, since 2013 the Greek government's budget deficit has been narrower, as a share of output, than Portugal's, and not much different from France's:



Nor is this performance driven by the Greek government's relatively low interest burden. Even excluding interest payments, the Greek government's budget balance has consistently been tighter than France's and generally narrower than Portugal's:



So what explains Greece's unique dependence on "official sector" funding? And why is there still so much disagreement between the IMF and the Eurogroup over what should be included in the latest financing package for Greece, which in theory was agreed to last year?

As is often the case when trying to understand the euro crisis, the European Central Bank deserves a decent chunk of the blame. In February, 2015, the ECB stopped accepting Greek sovereign bonds as collateral, although this may soon change. (But not *that* soon.) Even if it does, Greek debt is still ineligible for the public sector purchase programme, which is a strong signal private investors should demand relatively high interest rates to compensate for the risk of loss.

If the ECB declared it would purchase Greek government bonds in size, as it has with most of the other countries in the euro area — including Portugal, which is rated "junk" by Fitch, Moody's, and S&P — it's reasonable to think traders would remove some, if not most of, the substantial risk premium currently embedded in those bonds. That would make it easier for the Greek government to fund itself in the market by issuing new debt to replace maturing notes, as most governments do, rather than beg for financing from neighbouring governments.

For reference, the Portuguese government's 3-year yield is around 1 per cent right now, while Greece's is around 7-8 per cent. It's not obvious there are meaningful fundamental differences in Portuguese and Greek sovereign credit risk, apart, of course, from the attitude of the ECB, which, by extension, affects the judgment of investors. Both have slow growth, terrible demographics, high debt, and lost lots of export market share in the 2000s. Aside from how they're perceived, the only real difference between the creditworthiness of the two countries is Greece's debt service burden is lower.

Besides the ECB, the other obstacle to private investment is the official figure on debt to income. If you believe IMF data, the Greek government owes nearly 180 per cent of annual output in a currency it can't print. Anyone who was reticent to lend back in 2011 has little reason to change their attitude now since the debt burden, officially, hasn't changed at all. In fact, the prospects might appear *worse* now than then, because any private creditor would, presumably, have a subordinate position relative to the "official sector" creditors.

Even if you (reasonably) assume private investors are sensible enough to:

- Look at the Greek government's actual debt service burden, rather than a number people in charge of the bailout loans admit is "meaningless"…
- Are aware of the protections afforded to them by Greece's repayment schedule, since any bonds maturing before (at least) 2022 are effectively senior to the "official sector"…
- Know the exchange bonds issued in 2012 are legally as senior as loans provided by the European Financial Stability Facility…

…They *still* might consider the headline number a deterrent to invest.

After all, as late as June, 2015, the headline debt/GDP number was the basis of the IMF's "debt

sustainability analysis". Focused on lowering this figure from about 180 per cent to around 120 per cent by 2022, they and the other "official sector" creditors demanded the disposal of valuable state assets, tax hikes, and spending cuts.

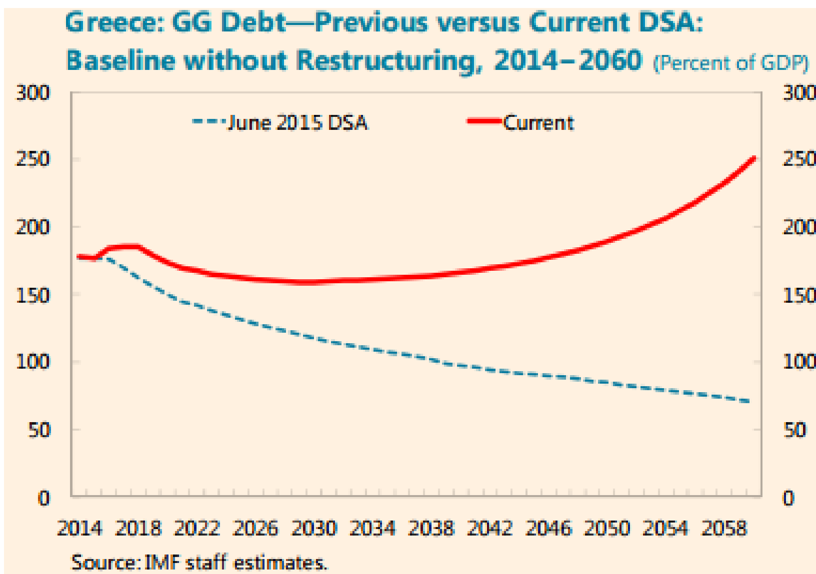
Paul De Grauwe has convincingly argued this analysis was flawed. According to him, the only thing needed to stabilise Greece's sovereign debt trajectory is a modest relaxation of austerity sufficient to let the country resume growing, which makes sense given what we know about the impact of government budget tightening during depressions and what this means for future debt service capacity.

After all, if you use the IMF's numbers and say the Greek government owed about €314bn of gross debt in 2015, the effective interest rate on those sovereign obligations was only 2 per cent. That's the same as in France, and significantly lower than the 3.0 per cent effective rate paid by the Italian government and the 3.2 per cent rate paid by the Portuguese one.

If those interest costs could be sustained, Greece's sovereign debt ratio could be stabilised at its current level with an average primary budget deficit of -1 per cent of GDP and yearly average growth in nominal output of just 3 per cent. These maths could even allow for some temporary deficit spending to reflate the economy.

That's not what the "official sector" recommended, however, because of their firm belief the persistence of the Greek depression was due primarily to the government's unwillingness to implement "reforms" *and* their conviction the Greek debt/GDP ratio needed to plunge. We therefore shouldn't be surprised rational and knowledgeable investors might not want to put any money in the country as long as the IMF and the Eurogroup were working off the 180 per cent number.

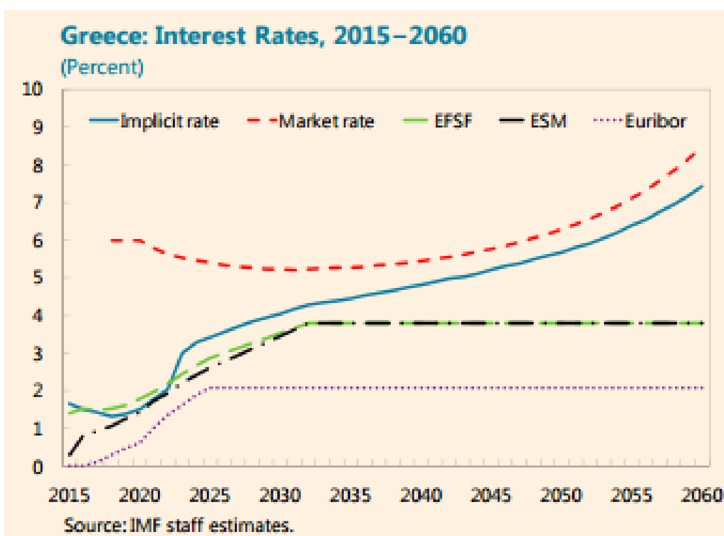
To its credit, the IMF has recently concluded "the debt targets and framework agreed in 2012 are no longer meaningful for assessing debt sustainability", and has lowered its long-run primary budget surplus target. However, the latest "debt sustainability analysis" still includes plenty of language about the sovereign debt-to-GDP ratio and even includes this handy chart to justify its prescriptions for additional maturity extensions, payment deferrals, and interest rate caps:



That estimate, in turn, is based on the IMF's assumption market interest rates on Greek sovereign are destined to be significantly higher than Greece's nominal output growth.

Part of that is due to extreme pessimism about the recovery potential of the Greek economy. The IMF now estimates 20 percentage points of Greece's 25 per cent unemployment rate is "structural". (Greece's jobless rate never went above 13 per cent from 1998 until the end of 2010.) The IMF also thinks the country's real output is only about 6.5 per cent below where it "should be", even though Greece's GDP is about a quarter below its pre-crisis level.

Perhaps even more importantly, the IMF believes markets are destined to charge the Greek government a fat spread, forever:



Why?

The IMF thinks investors will demand a credit risk "premium of four basis points for each 1 percent of GDP in debt above the Maastricht limit". (Related.) If correct, this means the official headline debt number will become increasingly important as the concessional loans from the

"official sector" get replaced by ultra-expensive funding from the markets. Thus the IMF forecasts an unsustainable upward spiral in the debt burden in the absence of significant relief or implausibly large primary budget surpluses.

So even if Greece's government debt/GDP number is qualitatively different from figures in other countries lacking monetary sovereignty, it still matters. The higher the ratio, the tougher it will be for Greece to ever return to the markets as a normal country and the longer it will remain dependent on the "official sector" — no matter how low its current debt service costs.

As Daniel Davies put it, the number should be understood as a "political quantity" that gives the country's European creditors "the kind of political control that they feel they need to have". If the total interest burden were the same but the headline debt number were lower, investors would be less afraid to lend and official creditors would have little leverage to demand further tax hikes and spending cuts. Just look at Spain and Portugal.

(The big objection to this line of thinking is that, in 2014, private investors were briefly willing to bet on Greece by buying new bonds and accumulating stakes in Greek banks, even though the debt numbers were the same then as now. However, this was right at the peak of global risk appetite, which has retreated somewhat since then. We'd also note politicians in the then-ruling New Democracy party spent the second half of 2014 attempting to scare voters and investors with tales of bank runs and a return to the drachma if Syriza were to win any elections, while the ECB stopped accepting GGBs as collateral in the beginning of 2015, as we noted above.)

But what if the Greek government's debt level were actually far lower? We're going to dig into the details of the argument in part 2.

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