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What if Greece got massive debt relief but no one admitted it? (Part 1)

Matthew C Klein Author alerts May 13 21:03 7 comments

Time is a flat circle, which is why the Greek government is set to run out of money before debt payments are due to the European Central Bank in July — just like last year, and despite last summer's supposed deal between the Greek government and its various "official sector" creditors.

As before, the immediate cause of this latest crisis is the persistence of disagreements about the size of the budget surpluses (excluding interest) the Greek government is expected to generate, the specific "reforms" the government needs to implement, and the need for debt relief. The fundamental cause, however, is that the Greek government can't raise money from the private sector at reasonable rates.

Why?

According to the latest figures from the International Monetary Fund, the Greek government owes almost 180 per cent of the country's yearly output and this debt is denominated in a currency the Greek government can't print. Creditors rarely get all their money back in those sorts of situations, so they're demanding high interest rates to compensate for the risk of large losses.

The high external debt level is also why ratings companies have classified Greek sovereign bonds below "investment grade", which in turn prevents Greek government bonds from being purchased by the European Central Bank unless the country is in a "programme" approved by the IMF and company, which is yet another clear signal private investors should stay away.

Thus the Greek government must regularly beg its "official sector" creditors for money needed to cover any spending beyond what's collected in tax, even though almost all the funds raised this way in the past few years have been used to cover payments on earlier loans made by those same creditors, rather than spending on actual Greeks.

The result of all this: recurring crises, punishingly high costs of capital, depressed asset values, a dearth of investment, catastrophic unemployment, and one of the largest sustained declines in output since 2008 of any country in the world since 1980. The only places to have done worse over the same length of time either suffered civil wars, collapses in the prices of key commodities, or both.

But what if the IMF's number is wrong because the debt has already been reduced? What if the Greek government's net debt is really less than 40 per cent of GDP, when properly counted? And what if misconceptions about this number have deterred private investment and encouraged "official sector" creditors to demand bigger primary budget surpluses than are really necessary, worsening Greece's suffering?

These are the contentions of Paul Kazarian, of Japonica Partners, although he is far from alone. We recently had the chance to discuss these ideas with him one-one for several hours.

Before we get to his argument in part 2 — it's both technical and somewhat contested — it's worth understanding exactly *why* Greece's debt burden matters, whatever you think it is.

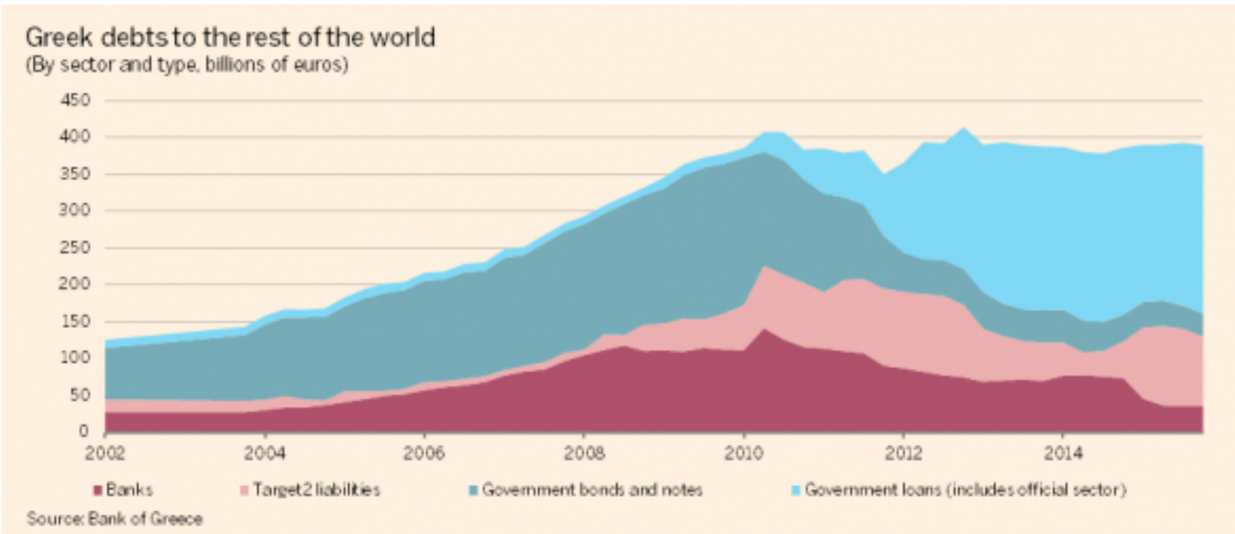
Borrowing comes with two big risks.

First, unlike equity investors, lenders expect to be repaid on a fixed schedule. That removes valuable flexibility when seemingly good ideas turn out badly. When borrowers are forced to keep servicing their debts to foreign creditors out of incomes smaller than expected, money gets sucked out of the economy that could have been better spent on new domestic investments, or even just basic necessities. And if borrowers default, they're often forced to sell valuable assets at low prices, which reduces everyone else's net worth and depresses the economy further.

Second, many borrowers, especially governments and businesses, rarely expect to repay all their debt at once when it comes due, instead preferring to roll over maturing debts into new ones. This isn't usually a problem, since investors generally want to own some fixed income and would whine about asset shortages if all debts were repaid, but it makes these borrowers vulnerable to changes in investor opinion. Massive spikes in interest rates, sharp downturns in spending, waves of defaults, and collapsing asset values are generally among the consequences. Being able to limit this risk is one of the main benefits of having your own currency.

These two dangers often reinforce each other even though they are fundamentally separate. Lenders worried by how much their debtors have borrowed, and sceptical of their debtors' ability to keep making payments in a downturn, are rational to pull funding and refuse to refinance maturing debts at anything but punitively high interest rates. And debts that look sustainable at one set of interest rates might be impossible to service if creditors refuse to roll their loans. *Perception determines reality*, as is often the case in finance.

Now for some necessary history. In the years leading up to 2008, the Greek economy grew rapidly and foreigners were keen to lend to Greece's government and its banks:



Of the total growth in Greece's external debt from 2002, when the data begin, through the middle of 2008, about 44 per cent went to the banks and 54 per cent went to the government. (Greek banks bought plenty of Greek sovereign bonds, but Greek households and businesses also took advantage of ample credit and a strong economy to rapidly amp up their borrowing, so this isn't purely a story of fiscal profligacy. Household debt grew at an average rate of 22 per cent per year from 2000 through the middle of 2008, while nonfinancial corporate debt grew at an average yearly rate of 14 per cent.)

Starting in 2009, the vulnerabilities created by these inflows were transformed into a crisis.

First, ratings companies began downgrading the country because of the size of Greece's sovereign debt, its budget balance, and its current account deficit. None of those facts were new, of course, but the interpretation of those facts had changed. Investors, having been burned so badly elsewhere, were (reasonably) demanding greater compensation for risk-taking than they had before 2007-8. The difference between yields on Greek government bonds and German equivalents began to widen, although was still quite low in absolute terms.

Next, the quality of Greece's official statistics came into question. Shortly after that, troubles in Dubai demonstrated how problems in housing or banks could flow through to sovereign borrowers. Yields kept rising and debate began over whether Greece and other troubled countries would be forced to default, exit the euro area, or both. Subsequent revelations in the beginning of 2010 made it clear the government had creatively manipulated its borrowing figures for years.

Regular readers should know the gist of what followed. Eventually, the loss of investor confidence and the absence of a lender of last resort made it increasingly difficult for the Greek government to continue to making interest payments and, more importantly, made it much tougher for the government to roll over its maturing debts into new instruments at affordable yields. This created pressure to raise taxes and slash government spending, which made the downturn — and debt outlook — even worse.

By May, 2010, Greece was thought to be cut off from the financial markets so its government got emergency loans. The combination of guaranteed funding and policy changes was supposed to restore investor confidence and allow the Greek government to return to the markets after the programme had ended.

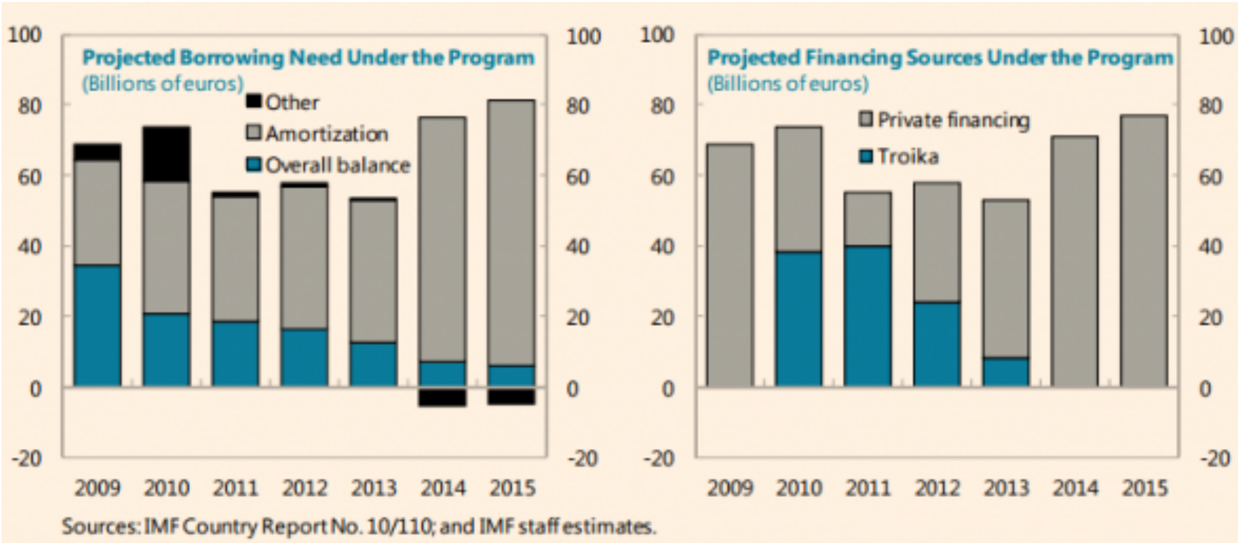
It didn't work.

One reason: the IMF and the other "official sector" creditors recommended "frontloaded" fiscal tightening during the teeth of the downturn, even though that mostly defeated the purpose of getting emergency loans in the first place and ended up making it less likely creditors would get repaid in full and on time.

The IMF claims they did the best they could given the amount of money available. On the other hand, they didn't disburse all the money up front, they admit they severely underestimated the impact of austerity, and they also admit "the adequacy of the program financing required favorable assumptions". In particular:

> Markets were concerned about the problem of large repayment obligations in 2014 and 2015 after the program expired. The financing strategy assumed renewed market access from 2012 yet the composition of debt holders would now deter private lenders since official lenders tend to be senior creditors.
>
> Subsequent research also suggests that the market access assumption, assessed in terms of rollover rates, was sanguine compared to past experience in emerging markets facing exogenous shocks. However, Greece's advanced economy status and its membership of the euro area may have been considered as modifying factors.

The emergency loans were never designed to be big enough to cover all of the Greek government's funding needs. Private creditors were expected to keep lending (some) even in 2010-2012. The chart below, again from the IMF's autopsy in 2013, and based on Table 3 from the original programme proposal from May, 2010, shows how much debt issuance was expected back when the programme began in 2010, where the money raised would go, and who was supposed to provide the money:



You can see, on the left side, the extent to which most of the Greek government's borrowing needs came from interest payments on old debt (included in the blue bars as part of the overall budget balance) and from replacing maturing debts with new ones (the grey bars), while on the right side, you can see how the IMF expected the emergency lending to be far smaller than the total amount the Greek government needed to borrow. Even in 2011, the year of maximum danger, the IMF expected 35 per cent of private creditors to rollover maturing Greek sovereign obligations into new debts.

The problem: if private investors thought the debt burden was too high in 2010, if they could see the debt burden wasn't getting smaller anytime soon, and if had just watched their claims get superseded by a whole new class of senior creditors, why would they keep lending money to the Greek government? Thus bond yields kept rising, fears of euro exit grew, and the economy continued to collapse.

In 2012, the "official sector" lenders realised they needed to do something different. Over the course of the year they made new loans at low interest rates, lowered interest rates on existing loans, gave the Greek government much more time to repay existing loans, remitted profits from the ECB's holdings of Greek government bonds back to the Greek government, and forced private lenders to accept getting repaid less than originally owed, among other things.

The net effect was to sharply reduce the present value of the Greek government's debt burden. According IMF data, the Greek government spent about €15 billion, or 7.3 per cent of GDP, on debt interest payments in 2011. For perspective, the Italian government was spending 4.4 per cent and the Portuguese government was spending 3.8 per cent.

By 2013, the Greek economy had shrunk by 13 per cent, in nominal euro terms, yet the sovereign debt interest burden was now 4.0 per cent of GDP, against 4.5 per cent for Italy and 4.2 per cent for Portugal. Put another way, the debt modifications in 2012 cut the amount spent by the Greek government on interest payments by more than half.

Subsequent debt modifications and the general decline in euro area interest rates have cut the amount the Greek government spends on interest payments by another 12.6 per cent. Interest expense was 3.6 per cent of Greek GDP in 2015, compared to 4.0 per cent in Italy and 4.1 per cent in Portugal.

So why didn't the 2012 modifications end the crisis?

My colleague Martin Sandbu puts it well:

> The problem is the chill caused by the uncertainty the debt overhang causes: will the debt service cost at some point increase (perhaps to crippling levels), and will there be another refinancing crisis whenever a large portion of debt is set to mature? It is this uncertainty that must be erased for investment to pick up.

In other words, investors don't care about the decline in the interest burden nearly as much as they worry, reasonably, about the headline debt figures. This makes it impossible for the Greek government to fund itself in the markets at reasonable rates, leaving it dependent on the whims of "official sector" creditors to make its small interest payments and roll over its large debts.

This is why it matters whether Kazarian is right about the accounting treatment of Greek sovereign obligations. There are plenty of weak economies in the euro area with miserable productivity growth, terrible demographics, and lots of debt. Greece isn't that different except insofar as it's excluded from ECB bond-buying and insofar as the markets and ratings companies treat it as a pariah.

So if the Greek government's actual debt number were far lower than what's commonly reported, investors would have little reason to charge it more than they demand from Portugal. And that would have big implications for an economy wracked for years by uncertainty about debt default, sky-high capital costs, and outside demands for "structural reform" and budget surpluses.

In part 2, we'll look at why exactly Kazarian thinks the Greek government's net debt is only 39 per cent of GDP, rather than 177 per cent, as well as some potential objections. In part 3, we'll imagine what sorts of budget surpluses would have been required to make the Greek government compliant with Maastricht criteria for debt levels by 2020 under different assumptions of the impact of the 2012 modifications, in comparison to what "official sector" creditors actually demanded.

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