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The Debate on Greek Public Debt

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During the six-year Greek crisis, Greece was offered substantial debt relief through the Private Sector Involvement (PSI) of February 2012 as well as maturity extensions, interest rate reductions or even a grace period in its interest rate obligations. Yet, at the end of 2015, Greek public debt amounted to €321.3 billion (State) or 183.5 percent of GDP and approximately €309 billion (General Government) or 177.8 percent of GDP and was expected to grow bigger along with a continuation of the 2015 recession. By traditional standards of cross-country comparisons, the current debt-to-GDP ratio is overwhelming in size. It is greater than in other European countries with large public debts, like Italy (132.8 percent) or Portugal (129.1 percent).

Greek debt sustainability is the topic of economic analysis and heated political debate. Opinions vary. In 2014 the IMF used to think the debt is sustainable, but with the 2015 change in the country's political and economic environment, it now has an opposite view. It claims that with realistic productivity and growth forecasts over the next 10 to 20 years and no policy change, the Greek public debt is unsustainable. According to Poul M. Thomsen, sustainability requires both a substantial reduction in annual pension expenditure and further debt relief.

Most Europeans, however, continue to argue that debt is sustainable, especially if the Greek government were to bite the bullet and begin slowly reducing the large size of annual pension expenditure, say from 10 percent of GDP to around 2.5 percent, which is the European average. They also point to a number of special characteristics that differentiate Greek debt from other country debts and render the traditional Debt-to-GDP statistic an unreliable indicator of Greek debt sustainability.

First, approximately 68.1 percent of Greek debt is owned by other countries or institutions (ESM, IMF), hence acquiring political characteristics. Second, unlike other country debt maturities, the Greek debt maturities are very long, stretching all the way to 2059.

The weighted average maturity is 16.5 years. This facilitates the Greek government as it does not have to revisit the markets frequently in order to refinance its debt. And since very long term debt acquires equity characteristics, Europeans now share some common interests with Greeks. Third, the average interest rate on the debt is very small, as if the country were rated in the AA category by the rating agencies, contrary to its dismal CCC or B- rating. Finally, until 2022 there is even relief from interest payments to the European Stability Mechanism.

The long maturities, the low yields and the grace period render the true (present) value of debt obligations very small relative to its nominal (face) value. As a result, debt sustainability is better described by the profile of future gross financing needs as a percent of GDP rather than the ratio of Debt -to-GDP. Those needs are relatively small over the coming years and nowhere near what they would have been implied by the 12 percent yields that the market requires today to lend to Greece for two or three years. This profile is also known for a long time into the future, providing increased certainty to the country. Clearly, it would also help if the floating interest rates that Greece has to pay, were transformed into fixed rate, taking advantage of the current low global interest rates.

Many believe there is no real debt overhang in Greece, which would prevent the private sector in the future to lend again to Greece at reasonable rates. After all, faced with an equally large Debt-to-GDP, the earlier coalition government of New Democracy and PASOK did manage to tap the markets twice in 2014. Thus prior to the 2015 change of government and the new recession, we did have proof that markets were willing to forget the past Greek fiscal deviations and focus primarily on the country's future growth prospects.

Today, there are three major stakeholders regarding the Greek debt: The IMF, the Greek government and European lenders. These three do not necessarily have similar political incentives; neither do they share similar forecasts on future Greek economic growth. As far as the IMF is concerned, it is quite clear what it believes. When it comes to the Greeks, it is important for them to focus on a well designed growth strategy and on building credibility in order to reverse the renewed decline in investment. While debt relief would be very welcome by the Greeks, it does not have priority when compared to the need for structural reforms and for a well functioning business environment. Finally, for European lenders, who are the ones to be called to provide debt relief, there is a strong temptation to condition it on the delivery of structural reforms. Care should be taken, however, so that this conditioning does not become a piecemeal process. The piecemeal nature of debt relief would create friction and keep a cloud of uncertainty in the market, thus preventing Greek interest rate spreads from declining quickly.

The Greek public debt is not a topic of discussion during the current negotiations of the Greek government with is lenders. Yet, it is likely to become one, once the first review of the 2015 3rd Economic Adjustment Program is concluded. Once Greece satisfies the requirements for a sustainable pension system and carries reforms in product and service markets, in the tax system or the public sector, then the IMF would become its natural ally in her demand for debt relief. However, if the review is not concluded within a reasonable time frame, the sliding economy is likely to take a major dive, which would be extremely difficult to subsequently reverse. At that point, major debt relief would become necessary.

Gikas Hardouvelis, former Minister of Finance and Professor of Finance & Economics at the University of Piraeus, was a speaker at Delphi Economic Forumon Saturday, February 27, 2016 at the European Cultural Center of Delphi.