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Thinking ahead for Europe

# Greece is solvent but illiquid: What should the ECB do?

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There is one feature of the sovereign debt crisis in Greece that is widely misunderstood, namely the effective debt burden of the country's government. Since the start of the crisis, its sovereign debt has been subjected to several restructuring efforts. First, there was an explicit restructuring in 2012, forcing private holders of the debt to accept deep haircuts. This restructuring had the effect of lowering the headline Greek sovereign debt by approximately 30% of GDP. Second, a series of implicit restructurings both lengthened the maturities and lowered the effective interest-rate burden on the Greek sovereign debt. As a result of these implicit restructurings, the average maturity of the Greek sovereign debt is now approximately 16 years, which is considerably longer than the maturities of the government bonds of the other eurozone countries. These implicit restructurings have also reduced the interest burden on Greek debt. In fact, the effective interest burden of the Greek government has been estimated by Zsolt Darvas of Bruegel to be a mere 2.6% of GDP.[1] This is significantly lower than the interest burden of countries such as Belgium, Ireland, Italy, Spain and Portugal.

As a result of these implicit restructurings, the headline debt burden of 175% of GDP in 2015 vastly overstates the effective debt burden. The latter can be defined as the net present value of the expected future interest disbursements and debt repayments by the Greek government, taking these implicit restructurings into account. Various estimates suggest that this effective debt burden of the Greek government is less than one-half of the headline debt burden of 175%.

From the preceding it follows that the effective debt burden of the Greek government is lower than the debt burden faced by not only the other periphery countries of the eurozone, but also by countries like Belgium and France. This leads to the conclusion that the Greek government debt is most probably sustainable, provided that Greece can start growing again (so that the denominator in the debt-to-GDP ratio can start increasing instead of shrinking, as is the case today). Expressed differently, provided that Greece can grow, its government is solvent.

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[1] Zsolt Darvas,"Greek choices after the elections", Blog Comment, Bruegel, Brussels, 23 January 2015.

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The logic of the previous conclusion is that Greece is solvent but illiquid. Today Greece has no access to the capital markets unless it is willing to pay prohibitive interest rates that would call into question its solvency. As a result, it cannot roll over its debt, despite the fact that the debt is sustainable.

There is something circular here. If Greece is unable to find the liquidity to roll over its debt, it will be forced to default. The expectation that this may happen leads to very high interest rates on the outstanding Greek government bonds reflecting the risk of holding these bonds. As a result, the Greek government cannot roll over its debt except at prohibitive interest rates. The expectation that the Greek government will be faced with a liquidity problem is self-fulfilling. The Greek government cannot find the liquidity because markets believe it cannot find liquidity. The Greek government is trapped in a bad equilibrium.

What is the role of the European Central Bank in all this? More particularly, should its outright monetary transactions (OMT) programme, introduced in September 2012, be used in the case of Greece? The ECB has sensibly announced that OMT support will only be provided to countries that are solvent but illiquid. But, as I have argued, that is the case today for Greece. So what prevents the ECB from providing liquidity? There is a second condition: OMT support is only granted to countries that have access to capital markets. This second condition does not make any sense, because it maintains the circularity mentioned earlier. Greece has no access to capital markets (except at prohibitively high interest rates) because the markets expect Greece to experience liquidity problems and thus not be able to roll over its debt.

The explicit aim of the OMT programme was to prevent such self-fulfilling expectations, which can push countries into a bad equilibrium. It is appropriate to quote Mario Draghi when he first announced the OMT programme: "The assessment of the Governing Council is that we are in a situation now where you have large parts of the euro area in what we call a 'bad equilibrium', namely an equilibrium where you may have self-fulfilling expectations that feed upon themselves and generate very adverse scenarios. So, there is a case for intervening, in a sense, to 'break' these expectations."[2] Greece today fulfils the conditions for liquidity support as spelled out by Draghi in 2012, yet Greece is excluded from this support, and as a result it is trapped in a bad equilibrium.

The use of OMT to provide liquidity support to Greece is made difficult by the fact that public authorities hold the largest part of the Greek debt. To solve this problem, it would be necessary for these public authorities to recognise that the market value of their claims on Greek debt is worth a fraction of the nominal value. These public claims could then be sold in the market at a price that comes close to the net present value of the future disbursements (interest plus capital). At that moment, the ECB could extend its OMT promise to these assets (bonds), thereby creating a market for them.

I am aware that this solution creates a political problem. Governments of the creditor countries will have to recognise the losses that they have already incurred on their claims on Greece. Politicians prefer to live in a fictional world, allowing them to pretend no losses have been made so that they can hide the truth from their own taxpayers. The solution proposed here forces these governments to acknowledge that losses have already been incurred. I conclude that providing liquidity to Greece is possible if governments are willing to stop hiding the truth.

[2] http://www.ecb.europa.eu/press/pressconf/2012/html/is120906.en.html

All this teaches us two lessons. First, the objective of the creditor nations today, including the ECB, in imposing tough conditions for their liquidity support is not to make Greece solvent but rather to punish it for its misbehaviour. The punishment is deemed to be necessary to avoid the risk of moral hazard. It is perfectly understandable that creditor nations are concerned about moral hazard. But it is precisely the desire to punish Greece by imposing additional austerity that makes it so difficult for Greece to start growing again and to extricate itself from the bad equilibrium.

A second lesson concerns the credibility of the future use of OMT. It clearly appears from the Greek experience that the willingness of the ECB to use the OMT programme is highly circumscribed. It is circumscribed by the ECB's desire to solve a moral hazard problem. The ECB seems to be saying that OMT will only be used when it can be certain that its liquidity support will not trigger misbehaviour. And this can only be achieved by imposing tough conditions. Behind the soft gloves of OMT is hidden a big stick. It is doubtful that future governments experiencing payment difficulties will accept to be beaten up first before they can then enjoy the benefits of OMT liquidity support.

Now that the European Court of Justice has given the legal clearance for OMT, the question arises whether the moral hazard hurdle to the use of the OMT will easily be overcome. I conclude that the credibility of the OMT programme to be used in times of crises is limited.