CEPS COMMENTARY
Thinking ahead for Europe

The Cost of Servicing Greece's Debt: A Sisyphean task?

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4 February 2015

Following the victory of Syriza in the Greek elections on January 25th, policy-makers, economists and concerned EU citizens are scrambling to understand the causes, modalities and consequences of a possible Greek default in order to anticipate and prepare for what is likely to unfold in the coming weeks and months. The debate on the sustainability of Greek public finances has often been characterised by a lack of clarity and even a certain degree of confusion. This brief note focuses first on the cost Greece faces in servicing its debt and then asks whether this is a manageable or a Sisyphean task. It concludes by reflecting on the political implications of the new government's announced intentions and whether these are being taken into account in the current debate over debt restructuring.

The amortisation of Greek public debt

With the deadline for reimbursing the IMF for one of its tranches rapidly approaching, repayment of this loan appears at the moment to be the most pressing problem in the public debate in Greece. On closer inspection, however, this should not be considered the country's main problem.

The public debt-to-GDP ratio of Greece is currently equal to about 175%, a value below the 230% level recorded in 2012, but above 120%, which is often considered the reference threshold for sustainability. What is most relevant to the current debate, however, is the fact that almost €320 billion of the government debt holdings are shared between the European governments (62%, including both the bilateral loans and those of the European Financial Stability Facility, EFSF), the European Central Bank (11%) and the IMF (10%). Only 17%, i.e. just a bit more than €50 billion, are in the hands of the private sector.Figure 1 shows that the main problem for Greece in the coming years is not to repay this debt to the European Union. Amortisation appears particularly burdensome in 2015 due to the quite large reimbursement of the International Monetary Fund loan under the first programme and to the Eurosystem for the bonds purchased under the Securities Markets Programme (SMP). But after those repayments are made and until 2020, total amortisation becomes much smaller, representing about 5% of GDP every year. This is the result of the decision taken by the Eurogroup on 13 December 2012,[1] when the maturities of the bilateral and EFSF loans were extended by 10 years to significantly reduce the amortisation burden.

[1] See www.consilium.europa.eu/press/press-releases/2012/12/pdf/Eurogroup-Statement-on-Greece/

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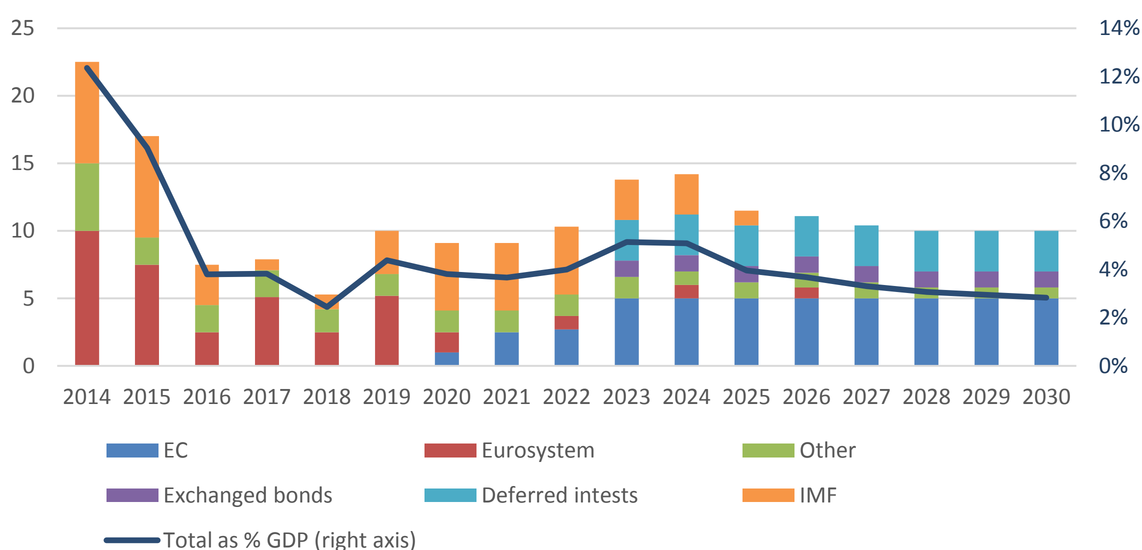
Figure 1. Amortisation of Greek debt (€ billion)



Source: Authors' elaboration based on IMF staff estimates, 2014.

As observed by Gros (2015), it may be tough for Greece to persuade the IMF to reschedule the payments due, but some room for manoeuvre should be possible with other creditors. So, would it make sense for the country to default now?

How much is Greece paying to service its debts?

In order to answer this question, one should look at the cost of servicing debt. There is some confusion on what Greece is really paying as a result of accounting rules.

Several OECD countries, including Greece, use accrual-based accounting. According to the accrual principle, transactions are recognised when they occur, even if payments are made later. This implies that there may be a discrepancy between the interest payment expenditure recorded in the balance sheet of the government and the actual financing need (money to be disbursed) for interest payments. This difference is quite important for Greece. For instance, in 2015, while the accrual accounting sets this expenditure at 4.9% of GDP, the financing need is actually on the order of 2.8%. This explains, at least partially, the different opinions reported in the media about the size of the burden of Greek debt.

Table 1 reports the amounts based on the accounting rules and the financing need and shows that the cumulated difference between the two measures over the period 2013-16 is on the order of €10 billion, which is not a negligible sum.

Table 1. General government interest expenditure in Greece: Accounting vs. financing need (€ billion)

	2013	2014	2015	2016	**Total**
Interest expenditure (accrual accounting)	7.2	7.6	9.1	10.1	34.0
Financing need (based on cash balances)	6.4	5.9	5.4	5.5	23.2

Source: Authors' elaboration based on IMF data (2014).

This large difference is mostly due to the deferral of interest payments approved by the Eurogroup on 13 December 2012. Interest payments on European Financial Stability Facility loans are deferred by 10 years to permit Greece to reduce substantially its financing needs until 2020. According to the EFSF, this measure was estimated in 2012 to lower the financing needs of the country by a total of €12.9 billion between 2012 and 2016.

In addition to the deferral of EFSF interest-rate payments, the Eurogroup also agreed in 2012 on the redistribution of the income generated by Greek government bonds acquired by the ECB under the SMP. Since this is part of the ECB's net profit, such income is distributed to all national central banks (NCBs) of the euro area according to their shares in the ECB capital key. Such net profits, in turn, are distributed by national central banks to their respective shareholders i.e. national governments.[2] The Eurogroup agreed that certain government revenues that emanate from the SMP profits disbursed by NCBs are allocated by member states (with the exception of those under an adjustment programme) to further improve the sustainability of Greece's public debt. This amounts to €6.6 billion over the period 2013-16 (€4 billion has been already disbursed until 2014). In addition to the SMP, those member states whose central banks hold Greek government bonds in their investment portfolios have committed to pass on any income to Greece that accrues to their national central banks stemming from this portfolio until 2020.[3] These income flows,[4] which amount to €2.2 billion for the period 2013-16, imply that over those years Greece can expect to receive a total of about €9 billion in Eurosystem-related income.

Overall, this suggests that, because of the agreements in place, the burden in terms of interest expenditure to service the large Greek debt is actually not so large. This has been reduced significantly after 2012 and, in terms of GDP, it is less than in other countries with lower debt-to-GDP ratios. Even if one compares figures based on accrual accounting, in 2014 Greece paid less than Portugal and Italy, which spent 5% and 4.7% of GDP, respectively.

The cost of servicing external debt

However, the cost of servicing *public* debt is not the only relevant indicator when discussing Greece's cost of servicing its debt. One of the main reasons why the Greek situation looked so dire in 2010 was due to the unsustainability of the high *external* debt (see Gros & Alcidi, 2011 and Alcidi et al., 2014). But is that still the case today?

A good approximation of the net external debt[5] is given by the cumulated current account balances over a quite long period of time. Figure 2 compares the performance of Greece relative to Portugal, which had a similar level of external debt relative to GDP in 2009, just before the crisis erupted. Despite a similar starting point, Greece continued to cumulate large amounts of debt until 2013, when it reached almost 150% of GDP, and then it started to decline. By contrast, by 2014, Portugal managed to return to its 2009 level, thanks to the progressive improvement in the current account balance.

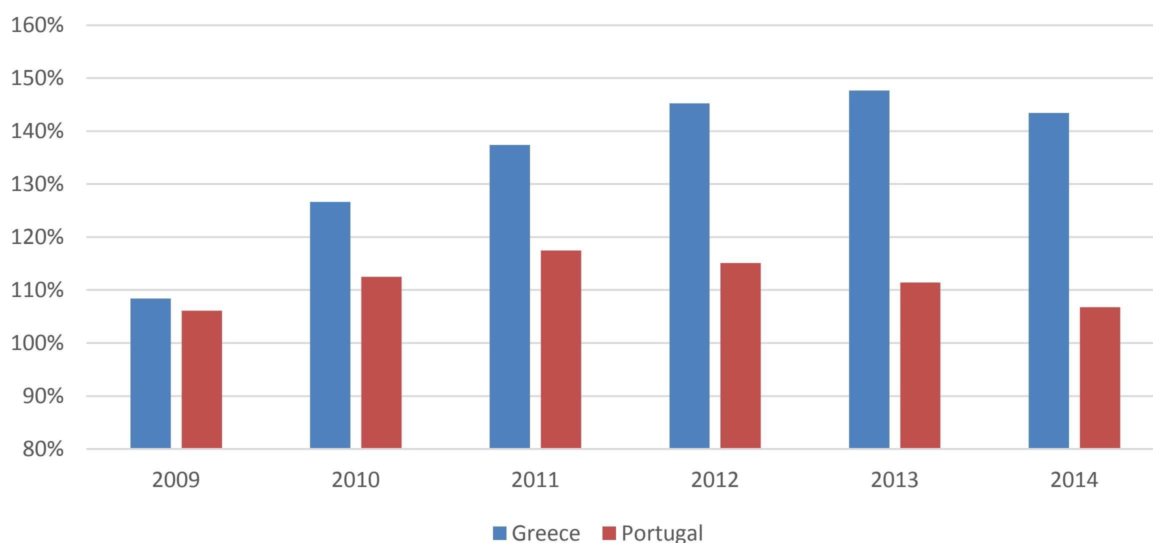
[2] See http://www.ecb.europa.eu/pub/pdf/other/130515letter_hoangngocen.pdf.

[3] See https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128075.pdf

[4] Known as the Agreement on Net Financial Assets.

[5] The correct concept of debt to monitor in order to assess the sustainability of the external debt (i.e. debt held by non-residents) to be served is net debt (Alcidi & Gros, 2011).

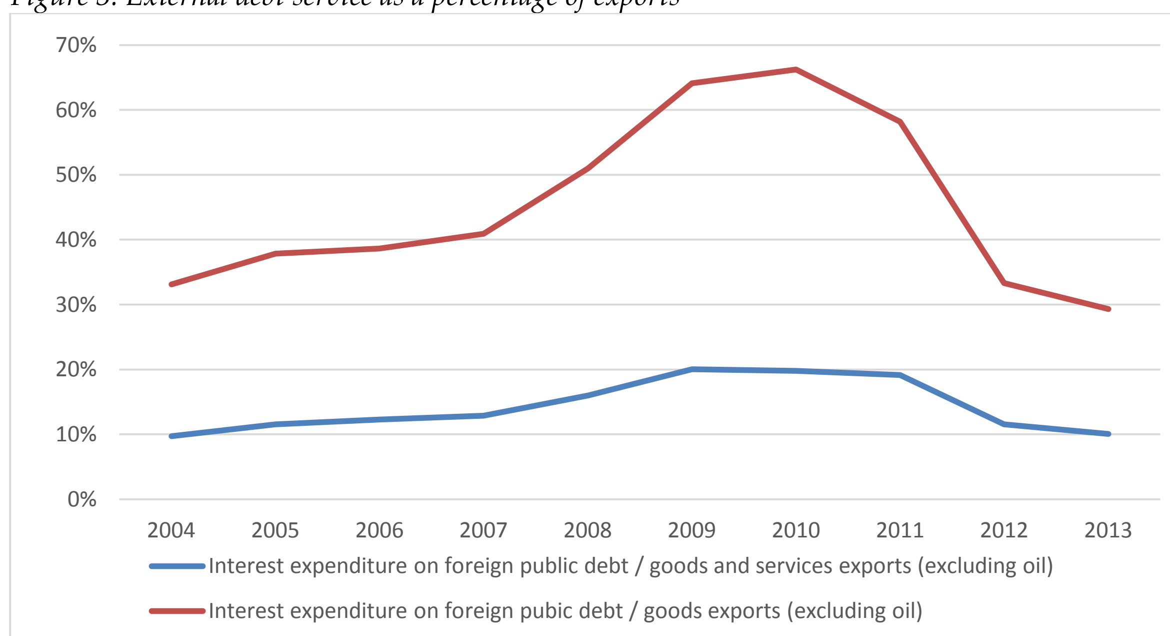
Figure 2. Greece vs. Portugal: Net external debt (sum of current account balances) 2009-14



Source: Authors' elaboration based on AMECO data (2015).

How large is the burden of servicing the external debt in Greece? Since foreign debt has to be serviced through a transfer to the rest of the world, it is useful to relate debt service to exports of goods and services. Indeed, exports indicate the country's capacity to transfer real resources to its foreign creditors equal to the contractual payments. Given the ultra-low interest rates on the debt held by official investors (which is, of course, part of the external debt), as shown in Figure 3, in 2013 Greece had to devote about 10% of its exports towards paying interest on its foreign debt. This has been declining over time and it is low relative to countries with similar levels of net external debt. In other words, Greece does not face exorbitant interest payments on its external debt.

Figure 3. External debt service as a percentage of exports



Sources: Authors' own elaboration based on balance of payments data, Central Bank of Greece and statistics on the external sector.

Debt restructuring vs. budget balance surplus

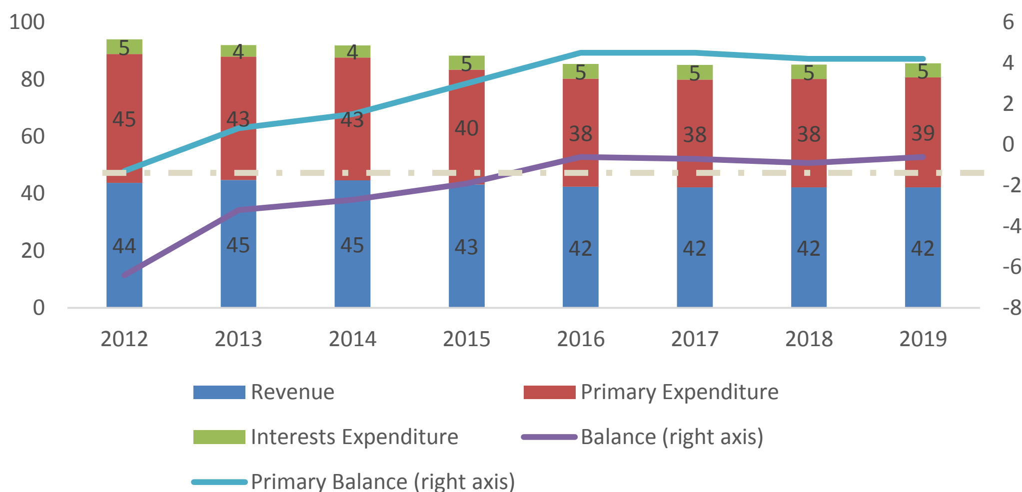
It should be recognised that the current debate is not really focused on whether Greek public finances are sustainable or not. It is driven by the argument that given the size of the debt, the ability to respect commitments vis-à-vis creditors is linked to the continuation of restrictive budgetary policy stances. In the recent elections, the Greek electorate unequivocally rejected such policies.

This argument deserves two considerations. First as shown in Figure 4, in the next few years the Troika plan foresees a gradual and moderate easing relative to previous years (Gros, 2015).

According to Figure 4 in terms of GDP, the tax burden should be gradually reduced while government spending will remain almost unchanged. When looking at the details of the expenditure, the two most politically sensitive budget items – spending on social security contributions and subsidies to the population – are expected to remain constant at around 21% of GDP. This is equivalent to an increase in nominal spending, since GDP is expected to grow in the coming years (after a growth of 6.2% in the third quarter of 2014 compared to the previous quarter).

The second consideration is based on the expectation that the fiscal stance can relax in the coming years, given that interest expenditures will not represent a problem (especially considering the financing need). To this should be added the likelihood that, if the new government proves willing to negotiate, the Troika will be open to offering some concessions in exchange for a commitment to run a substantive primary surplus in the coming years. It is important to stress, however, that the ability to run a primary surplus is a necessary precondition for effectively reducing public debt.[6]

Figure 4. Greek public finances as foreseen in the Troika V Review (% of GDP)



Source: Authors' elaboration based on IMF staff estimates, 2014.

[6] In a recent publication, the IMF looked at successful episodes of debt reduction in 27 advanced economies between 1980 and 2011. The research found that for all debt-reduction episodes, the combined growth effect (i.e. the sum of the impact of real GDP growth and automatic stabilisers) reduced the debt ratio by 2% of GDP, while the structural primary balance contributed to a debt reduction of 3% of GDP per year (IMF, 2014).

Political implications

The debate surrounding the restructuring of Greek public debt is quickly intensifying, and the announcement by Greek finance minister Yanis Varoufakis in London on February 2nd about a debt-swap plan (to replace the ECB holdings and the EU rescue loans) is very telling.[7] By declaring its willingness to be insolvent (even if only partially on official loans), the government is making it very difficult for Greek banks to access international financial markets. Securities issued by an insolvent country can hardly be used as collateral in refinancing operations, which are badly needed. At the same time, the Greek government will lose its ability to regain access to financial markets, which it had already tested last year (issuing about €3 billion of five-year bonds, offered in yields of 4.95%).

In his announcement, Varoufakis neglected to mention that the success of 'Brady-style' bonds relies crucially on the credibility of the commitment undertaken by the government. This is likely to be an issue for Greece. As shown above, the burden for Greece in servicing its debt (both government and external debt) is relatively manageable from an economic point of view, and even lower than in other euro-area countries. This situation means that the request to restructure the debt combined with the reluctance to negotiate a reduction in the primary surplus requested by the Troika (a ground on which it may be possible to find a deal) signals that the newly elected Greek government is not aiming at smaller surplus but rather at a looser fiscal stance. This would, of course, make it hard for lenders to accept a compromise. This may also explain why Varoufakis, when announcing the debt-swap plan, promised to post primary budget surpluses of 1% to 1.5% of GDP. The latter promise is strikingly inconsistent with the signalled stance and calls into question the credibility of the Greek government's undertakings.

This means that a Greek restructuring now would be a political choice and not an unavoidable outcome. For this reason, its implications go well beyond the economic consequences and financial market reaction. Of course, several scenarios are possible but there are two opposite outcomes that could materialise in the case of debt restructuring.

If debt restructuring emerges as a result of a breakdown in discussions with the Troika and comes as a unilateral decision, this would lead to Greece's exit from the E(M)U. Even if a debt swap planned is agreed, Greece will most likely lose market access for quite a long time (if the experience of Argentina can be of guidance). Of course with the exit from EMU, technically speaking, the Central Bank of Greece would reclaim monetary sovereignty and could finance the current expenditure of the government. This would give the new government the needed resources to pursue expansionary fiscal policies but would also result in rapidly growing inflation. The magnitude of the benefits from devaluation would probably also not be so large. The poor performance of Greek exports can be attributed not so much to price-competiveness factors, but rather to institutional factors.[8] The huge fall in wages and prices and the depreciation of the euro did not bring any export recovery. It is probably not by chance that Varoufakis' announcement does not mention EMU membership and that the new government has repeatedly affirmed the will to remain in the eurozone.

If the restructuring of Greece's public debt is in the end agreed with European lenders, this would certainly be beneficial to Greece, but it would have very large political implications for EMU. These implications would not only be of a financial nature, as a restructuring

[7] See article in the Financial Times: "Greece finance minister reveals plan to end debt stand-off", 2 February 2015 (www.ft.com/intl/cms/s/0/7af4252c-ab03-11e4-91d2-00144feab7de.html?siteedition=intl).

[8] See Bower et al. (2014).

without exit would imply monetary losses for the countries that lent the money to Greece – and not only for the ECB. It would imply, in fact, that some euro-area countries, for instance those still under a programme (Cyprus), or previously under a programme (Portugal and Ireland) or currently adjusting their public finances (Italy, Spain and France) would ask either for similar treatment or a significant relaxation of all constraints on budgetary policy and debt-reduction rules. Such requests would be politically difficult to refuse and the consequences potentially dramatic. Whether we like it or not, the current EMU system of governance is based on rules and the current EMU is not viable without rules (Alcidi et al., 2014). If there is a new consensus that rules should be removed, we must first have an alternative system in place; otherwise, EMU will face an existential threat – a situation that would benefit no one.

The current stance taken by the new Greek government may underestimate the EU's reaction and the fact that the EU's position vis-à-vis the country will have repercussions that go far beyond the country's borders. That said, however, we conclude by paraphrasing a famous expression of the French mathematician, physicist and religious philosopher Blaise Pascal: "Politics has its reasons, which economics does not know."

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