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Debt Is Back (It Never Went Away)

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OVERVIEW

Bottom Line: January provided a healthy reminder that debt overhangs do not go away. Eventually they undermine the economy and politics of the debtor country. What lessons will be learned?

Sovereign debt is back on the front pages of the papers, and there is a renewed focus on the global rise in indebtedness. The new Greek government's call for a substantial easing of its debt burden has been given the cold shoulder by European leaders and may be the largest obstacle to a deal keeping Greece in the eurozone. At the same time, Ukraine announced it would begin negotiations with creditors, leading bond prices to plunge on expectations of a restructuring. Falling oil prices are raising concerns about debt sustainability in Venezuela, Nigeria, and Russia (where the toxic mix of sanctions and oil prices led to a recent ratings downgrade). Though the stories behind these crises differ, they all highlight the political and economic dangers of failing to deal with a debt overhang. Together these developments represent a substantial shock to sovereign debt markets that produced attractive returns for investors in recent years. Is the party over?

GREECE: OLD IDEA, NEW PACKAGING

The new Greek government demands debt relief from its official creditors. Its current proposal offers to swap European government claims for a bond with payments linked to Greek gross domestic product (GDP), while the European Central Bank (ECB) would take a perpetual bond with ultra-low interest rates. The result, the government argues, would allow Greece to finance itself with small primary surpluses. The government would also abandon its International Monetary Fund (IMF)-backed program, leaving unanswered how, if at all, creditors would monitor and assess the country's commitments. Markets initially rallied on the news suggesting a less-rigid negotiating position than initial postelection comments signaled, but have since fallen after learning that the ECB would tighten conditions for Greek banks. Greek bond yields, at 10.3 percent, remain well below earlier crisis levels.

Government debt in Greece now exceeds 175 percent of GDP.

GDP-linked payments have a mixed history in debt markets. For private investors, they are often hard to price and it is questionable whether debtor countries receive fair value for what they offer. However, these payments have been a common feature of debt restructurings, including under the 1989 Brady Plan for Latin American debt relief, as the GDP feature provides an upside to participating creditors. Some countries, such as Chile, have used debt-for-equity programs to similar effect. Overall, there have been enough successes to make the theoretical case for an explicit shift from a debt instrument to one linked to capacity to repay. Though debt contracts often end up exhibiting equity-like features (because payments are restructured or deferred when times are bad), there is intuitive appeal and obvious political benefits to a proposal that explicitly does so.

In the official context, setting aside concerns about precedent, a central problem for the proposal from the creditors' perspective will be that—absent a monitored adjustment program—the incentives for slippage would be high. In this case, because the ECB would fund the country indirectly on a low-cost and unconditional basis (though its Emergency Liquidity Assistance program, or ELA) by providing liquidity to banks that in turn buy

the government paper, the temptation to rely on the central bank and defer tough decisions will be irresistible. For that reason, some economists have called for official debt relief to be tranched and linked to specific reforms.

It is hard to imagine these initial proposals being acceptable to European creditors, and a long negotiation lies ahead. In the meantime, two Greek banks have requested emergency support from the ECB through the Bank of Greece, highlighting the country's continuing funding needs. The fiscal position deteriorated sharply in the run-up to last month's elections, and even a small primary surplus will be difficult for the government to reconcile with its campaign promises. It is most likely that, even in an optimistic scenario, Greece will need continuing official support. Government debt, which now exceeds 175 percent of GDP and is mostly owed to the IMF and European governments, will continue to rise following years of crisis lending and a private sector debt restructuring in 2012.

I have argued elsewhere that the Greek government can produce a temporary growth surge inside or outside the eurozone, but that the main scenarios for doing so make consensual debt relief harder, not easier, to achieve. Without long-term growth, even substantial debt relief is a temporary palliative. Greece needs more than a fiscal-driven boost to growth to achieve longer-run competitiveness and sustainability; there is no path to normalization that does not involve a significant markdown of Greek debt. For now, Greece and its creditors are so far apart, their perceptions of their negotiating leverage so different, and time so short to reach an agreement, that the risk of failure seems higher than implied by market prices.

Growth in Greece could embolden antiausterity parties elsewhere.

The substantial losses that would result with either a Greek exit or capital controls would have broad repercussions, even though Europe is better prepared to deal with those contingencies now than it was from 2010 to 2012. These include large losses to holders of Greek debt, which are mostly European banks, and substantial moves in asset prices as investors adjust their views about the risks of investing in the eurozone periphery. Moreover, any growth in Greece could embolden antiausterity parties elsewhere in Europe. In a year, the debate may be over whether the rest of the periphery should copy Greece, not the other way around.

UKRAINE: A REPROFILING BY ANY OTHER NAME

Last week brought news that Ukraine will "consult" with its creditors "on how we can work together to improve the medium term debt sustainability of the country," in conjunction with negotiations to fix its failing IMF program. In plain speak, this means Ukraine will restructure its debt as a condition for continued IMF lending. Though debt has risen sharply in recent months, Ukraine's difficulty meeting near-term financing needs, rather than a clear calculation of debt unsustainability, that is driving the decision to restructure in the spring. The IMF has identified additional funding needs of $15 billion, and bilateral official contributions from the United States and Europe have fallen well short of that, leaving the Fund in the tough position of writing progressively larger checks, or seeking a "bail in" of private creditors.

The tremendous uncertainty stemming from the Russian conflict, as well as limited adjustment progress so far, would seem to call for a wait-and-see attitude, even though it is likely that deep restructuring will be necessary. It seems logical to support the financing for the program, keep the creditors in by pushing back all maturities a few

years, and decide on whether and by how much to ultimately reduce debt once the uncertainty is resolved. In IMF speak, that is "reprofiling."

Unfortunately, the willingness of the IMF to provide clarity on its approach seems to be limited by a broader debate over reprofiling. In a number of papers over the past two years, the Fund has pushed for strengthened rules making reprofiling a condition for IMF lending in certain cases where the Fund is providing exceptionally large loans and where debt sustainability is not assured. (Is it ever?) Those proposals have proven contentious because they seek to tie the hands of the Fund's shareholders and could significantly affect market dynamics. Moreover, an agreement with the major shareholders (notably the United States) is far from assured. The Fund cannot prejudge those negotiations, but as a result it seems unwilling to associate Ukraine with the initiative. That has created a great deal of uncertainty about what the Fund would like to see done. Some of the terms likely to come out of a negotiation between Ukraine and its creditors would differ from the reprofiling proposal. For example, I would expect all external debt maturities to be pushed back to maintain intercreditor equity, though the Fund's proposal anticipates that reprofiling would generally be limited to the three years of Fund arrangements under negotiation. The alternative would be a deeper restructuring to fix Ukrainian debt once and for all. That approach would deal with the overhang, but at the risk of getting it wrong and having to do it again in a few years. It would be a shame if the decision is made to restructure when a reprofiling better fits Ukraine's needs.

Ukraine will restructure its debt as a condition for continued IMF lending.

These counties are not alone: Oil exporting countries such as Venezuela and Nigeria are also struggling with debt burdens that they cannot handle with oil prices at current levels. It is often the case that difficult restructurings catalyze the policy community to strenthen the architecture for resolving debt crises. This may be such a time.

Looking Ahead: Kahn's take on the news on the horizon

The sanctions game continues

Further sanctions appear likely following intensified military attacks from Russian-backed separatists in southeastern Ukraine. So far, sanctions have not excluded Russia from the payments system, but that could change.

Eurozone easing may not be enough

The ECB's announcement of quantitative easing was well received by markets, but significant skepticism exists about whether it will be sufficient to restore above-trend growth.

Time for Abe to release his third arrow

Japan needs to boost its structural reform effort (the third arrow of Abenomics, along with monetary and fiscal policies), but will the government take the tough structural measures it requires?