

# **Research on Money and Finance**

## **Occasional Policy Papers**

**Greece Needs a Deep Debt  
Write-Off**

**Costas Lapavitsas SOAS/RMF  
Daniel Munevar CADTM/RMF**

**Occasional Policy  
Paper 10**

**May 2014**

## 1.A deep debt write-off for Greece

It is generally agreed that public debt continues to pose a major problem for Greece. The IMF expects it to decline to 124% of GDP by 2020, while annual rates of growth are projected at a little less than 3%. To achieve this target Greece has been forced to adopt highly restrictive fiscal policies, including the requirement of achieving a primary surplus of 4.5% by 2016. It is remarkable that policies of such severe austerity have been applied to a country that has suffered an economic depression since 2010. The outcome has been that the ratio of debt to GDP ratio now stands at 174%, much higher than 130% in 2009, when the crisis started.

In this context the fundamental problem posed by public debt in Greece is not merely the annual burden of servicing it but also the constraint that it imposes on economic policy. To service public debt the country is obliged to pursue a very restrictive fiscal policy based on high taxes and reductions in public expenditure, including public investment. Meanwhile, monetary policy is completely in the hands of the ECB, while the parlous state of the private banking system means that credit is in short supply. The implication is that the country cannot adopt policies that are urgently needed to boost demand, reduce unemployment and support growth.

Greece needs debt relief to generate additional fiscal space for the government, allowing it to adopt fiscal policies that could quickly facilitate recovery and growth. This is imperative in a country with adult unemployment currently standing at the extraordinary level of 27%. The real question is not whether but how to effect debt relief for the country. In this light there are two options.

First, there is the 'soft' option of consensually extending the maturity of debt and lowering the average interest rate, thus reducing the annual interest outlay. This form of debt relief is preferred by the EU and the current Greek government because it would leave the nominal value of the debt intact, thus avoiding major conflict with the official lenders by protecting their interests.

Second, there is the 'hard' option of writing off the nominal value of the debt (haircut), thus also reducing the annual interest outlay. This is advocated by several opposition parties in Greece and appears to have some support from the IMF, though there is no agreement on the extent of the write-off. It would face severe opposition from the official lenders and would necessitate hard negotiations that could possibly include some unilateral action by Greece, such as default.

This OPP considers the two options from the perspective of freeing up fiscal space to allow Greece to lift austerity and support its economy. Fiscal space is calculated as the savings from reducing the annual payment of interest, and thus relaxing the extremely restrictive targets for primary surpluses, while stabilizing the debt to GDP ratio. In effect, fiscal space measures the room that would be opened for government to follow more expansionary fiscal policies without running increased deficits, provided that debt relief became a reality. Put differently, it indicates the margin for alternative policies that would place growth and employment at the forefront, which is what Greece requires, rather than servicing the debt, which is what current policies do

The study uses a model of Debt Sustainability Analysis under fairly standard assumptions to compare a 'soft' option of reducing the interest rate by either 0.5% or 1% with a 'hard' option of a deep write-off lowering the ratio of debt to GDP to the Maastricht-imposed condition of 60%. The period of comparison is 2014-19.

The main conclusions are as follows:

- i) The 'soft' option would have a negligible impact on the ratio of debt to GDP, improving it by barely 5% by 2019. The reason is that Greek debt was significantly restructured in 2012 and the average interest rate has already been lowered to around 3%.
- ii) The fiscal space gained through the 'soft' option of reducing the interest rate by 0.5% would amount to just 0.8% of GDP per year from 2014 to 2019; if the reduction was 1% the fiscal space would average 1.6% of GDP per year. These are insignificant gains particularly in view of the current state of the economy
- iii) The 'hard' option would have a decisive impact on the ratio of debt to GDP since it would directly reduce the nominal value of the debt.
- iv) The 'hard' option would generate substantial fiscal space averaging 4.8% of GDP for the period between 2015-19. This corresponds to nearly 10bn EUR a year that would become available for public investment, wage and pension rises and welfare expenditures. This gain would be between six and three and a half times greater than that from the 'soft' option, depending on the interest rate reduction in the latter. Over 2015-9 the sum would become enormous for the depressed Greek economy.
- v) The 'hard' option would make fiscal stability easier to achieve than the 'soft' option, even though there would also be much more space for fiscal expansion. Under the 'hard' option government deficits could be reasonably maintained at low levels (say, under 3% of GDP), while also stabilising the ratio of debt to GDP.

In sum, the 'hard' completely dominates the 'soft' option, and indeed the latter offers few significant benefits. If Greece is to get out of its current predicament, it needs a deep debt write-off. Needless to say there would be major political, social and economic implications from adopting a policy of a deep debt write-off for Greece. There is an urgent need to discuss who would bear the losses, and it is far from obvious how such a policy could become politically acceptable to the lenders.

There is little doubt that adopting the 'hard' option would require hard negotiations and it might involve unilateral action on the part of Greece, since the lenders would have to absorb significant losses. The 'hard' option, therefore, carries risks and tensions, but it is hard to see what other path would make sense, given the current state of Greek economy and society. The alternative would be a continuation of the current austerity policies well into the 2030s. The next government of Greece will have some tough decisions to make for which it will need as much public support and participation as possible. It is imperative that the Greek people are presented with a clear set of choices and full information.

## 2. The burden of public debt in Greece

In 2009, as the Greek debt crisis was about to burst out, Greek public debt stood at 300bn EUR (130% of GDP). The debt peaked in 2011 reaching 355bn EUR (170% of GDP) before falling to 304bn EUR (or 157% of GDP) in 2012. However, by the end of 2013 and at the beginning of 2014 Greek public debt had again risen to about 320bn EUR (174% of GDP).

The drop of public debt in 2012 was the result of an effective default by Greece, the so-called Private Sector Involvement (PSI). The restructuring affected roughly 200bn EUR worth of privately held debt, and involved a deep write-off (haircut) in the region of 50% of nominal value as well as a debt buy-back. The bulk of the losses fell on Greek holders, including banks, social security institutions and small bondholders. Losses to banks were made good through fresh public borrowing, thus limiting the final reduction of public debt. The absolute level of debt, however, rose again in 2013 as the country continued to borrow from the Troika of EU, the IMF, and the ECB through its 'rescue packages'. As proportion of GDP, public debt reached its highest level in 2013 due to the collapse of the Greek economy in the course of Troika-led stabilisation.

Apart from the PSI default, Greek public debt has been thoroughly restructured during the years of the crisis in four important ways:

(i) The composition of the debt has been altered dramatically since 2010, when debt comprised primarily bonds governed by Greek law. At the end of 2013 Greek public debt comprised mainly long-term loans provided by official lenders under the terms of the two bail-out programmes in 2010 and 2011.

(ii) The weighted average annual cost of Greek debt fell precipitously from just over 4% in 2009 to just over 2% in 2012, though it seems to have crept up above 3% in 2013.<sup>1</sup>

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<sup>1</sup> See Greek Public Debt Management Agency, <http://www.pdma.gr/index.php/en/public-debt-strategy/public-debt/historical-characteristics/weighted-average-cost-maturity-of-annual-funding>

(iii) The weighted average maturity of Greek debt was extended significantly, rising from a little under 8 years in 2009 to 16 years in 2013.<sup>2</sup>

(iv) EU loans have provisions for extended grace periods, and therefore the maturity profile of government debt has improved substantially. During 2016-2036 Greece will face reduced annual repayments varying mostly between 5bn EUR and 10bnEUR.<sup>3</sup>

The restructuring of debt by lowering its cost and lengthening its maturity has been achieved mostly through the loans provided by the EU which, after adopting a punitive outlook in 2010, eventually came to realise that Greece was basically insolvent and could not deal with high interest rates and short maturities.

Despite these profound changes in the volume and composition of debt, the Greek economy has been extremely weakened and can hardly cope with the burden of public debt standing at 174% of GDP. The country has faced a depression that has led to contraction of GDP by almost 25% since 2008, nearly 22% of which has occurred under the stabilisation programme. The depression is gradually coming to an end and perhaps there will be some positive growth in 2014. However, adult unemployment currently stands at 27%, consumption is still falling, private and public investment have collapsed, exports have been declining rapidly since the last quarter of 2013, industrial output remains very uncertain even after a contraction of 35% since 2007, and retail sales are flat-lining at about 70% of their level of four years ago.<sup>4</sup> This is a profoundly weakened economy, and it is very difficult to identify any sources of sustained and rapid growth in the near future.

In this context the servicing of Greek public debt continues to impose a significant burden on a prostrate economy, despite the lowering of interest rates, the lengthening of maturity and the grace period attached to Troika loans. The problem with Greek public debt, however, is not only the burden of annually servicing it but even more the tight constraints that it has imposed on fiscal policy. The conditionality attached to the bail-out loans has emphasised fiscal stabilisation above all, forcing the government to aim for primary surpluses with the aim of repaying debt and reducing it to 124% of GDP by 2020. From a macroeconomic perspective it is simply absurd to aim at primary surpluses of 1.5% of GDP in 2014 rising to 4.5% of GDP in 2016, while the country is in the midst of a devastating depression. The Troika programme has forced Greece to apply incredible fiscal constraints at precisely the worst moment.

Even more absurd, however, is the pride that the current Greek government has taken in achieving a significant primary surplus in 2013, well ahead of time. The magnitude of the surplus depends on the method used, and Greece has received a special dispensation to

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<sup>2</sup> See Greek Public Debt Management Agency, <http://www.pdma.gr/index.php/en/public-debt-strategy/public-debt/historical-characteristics/weighted-average-maturity>

<sup>3</sup> See Greek Public Debt Management Agency, <http://www.pdma.gr/index.php/en/public-debt-strategy/public-debt/maturity-profile-en>

<sup>4</sup> For several of these figures see ElStat, <http://www.statistics.gr/portal/page/portal/ESYE>

exclude expenditures such as the recapitalisation of banks from the calculation. Nonetheless, the government has recently announced that the country has achieved a primary surplus of perhaps 1.5bn EUR in 2013, and the figure has been implicitly confirmed by Eurostat. Achieving a primary surplus so rapidly has involved extremely restrictive fiscal policies (notably high taxes and reductions in public investment) at a time when unemployment has been at record levels. The government has subsequently announced that it would distribute roughly 500mn EUR of the surplus as a subsidy to poorer families a few weeks before the Euroelections of May 2014!

The reward for the government has been its return to the international bond markets in April 2014, barely two years after the PSI default. Aided by extremely liquid conditions in the markets and rapidly declining bond spreads across the Eurozone, Greece was able to issue 3bn EUR worth of 5 year bonds at 4.75% in a heavily oversubscribed issue. The successful return to the markets - even under limited and controlled terms - indicates the conviction of lenders that the acute period of the Greek debt crisis is over. Greece is not likely to declare default in the short term due to an inability to service its debt. The restructuring of the debt and the ferocity of the fiscal austerity have seen to that. It remains to be seen, however, whether the markets are right in the medium term given the burden of Greek debt and the state of the economy.

The reason is that any dispassionate analysis of Greek public debt will confirm that the country will need substantial debt relief, if it is to acquire the fiscal space needed to boost growth and reduce unemployment. By the same token, as long as the volume of public debt remains at current levels and in view of projected rates of growth, there is no prospect of Greece smoothly accessing the international financial markets in the medium term. In short and despite the stabilisation that has been achieved during the last two years, the real question is not whether Greece will have another bout of debt restructuring, but rather what form the restructuring will take. In this respect there are two fundamental choices, given that the great bulk of Greek debt is currently owed to official lenders, including the IMF.

The first is to go for the 'soft' option of lowering the rate of interest further, perhaps locking the reduction in as a fixed rate for a long period of time, as well as lengthening the term to maturity. This appears to be the preferred path of the current government and possibly of the EU itself. The Net Present Value of Greek debt would inevitably decline if relief was offered in this fashion, but there would be no haircut of the nominal value of debt which would be extremely difficult for official lenders to accept, including a series of parliaments in Europe. The trouble is that this option will not lift the pall of austerity on the country and nor will it create much fiscal space for Greece, as is shown in this OPP. This option, therefore, bodes ill for the country's future growth prospects.

The second is to go for the 'hard' option of a write-off (haircut) that would deeply reduce the nominal value of the debt. This appears to be the policy that the opposition parties in Greece prefer, though the size of the haircut is rarely specified by its advocates. There is little doubt that such a write-off would allow Greece to lift austerity by creating ample fiscal space which the economy desperately needs at present to return to growth. The analysis in the rest of

this OPP leaves no room for doubt regarding the superiority of the ‘hard’ option. The difficulty, of course, is that a deep write-off would involve major losses for lenders rising to hundreds of billions of euros. It would thus lead to profound ructions with the EU and place the country’s membership of the EMU at profound risk. This is the hard choice that would face an alternative government in Greece.

The rest of this OPP undertakes an assessment of the fiscal implications attached to both options. Using a standard Debt Sustainability Analysis, we make projections regarding the fiscal space associated with each of the policy options. By fiscal space we refer to the ability of the Greek government to increase fiscal expenditures without inducing an increase in the debt to GDP ratio. Section 3 describes the methodology and data sources used for estimation. Section 4 analyses the medium term fiscal implications of reducing the interest rate of Greek public debt, i.e., the ‘soft’ option. Section 5 examines the ‘hard’ option of a debt write-off and its implications for the fiscal space of the country.

### 3. Methodology and baseline scenarios

The technical discussion in this OPP is based on the model of Debt Sustainability Analysis (DSA) developed by the IMF.<sup>5</sup> The model allows for projecting the evolution of public debt in the medium term based on a series of macroeconomic assumptions. The basic equation that underpins the model can be written as follows:

$$\partial_{t+1} - \partial_t = (i_{t+1} - \pi_{t+1} - g_{t+1}) \partial_t - \rho_{t+1} - tb_{t+1}$$

Where:

$\partial$  is the debt stock

$i$  is the nominal interest rate

$\pi$  is the GDP deflator

$g$  is the real GDP growth rate

$\rho$  is the primary fiscal balance

$tb$  represents other non-debt creating inflows (grants, privatisations, etc.)

Thus, if  $tb_{t+1} = 0$  and  $(i_{t+1} - \pi_{t+1} - g_{t+1}) \cong 0$ , debt would increase (decrease) in case of a primary fiscal deficit (surplus). The model is useful as it allows us to assess the sustainability of fiscal policy in the medium term given a series of assumptions regarding the future evolution of key macroeconomic variables, such as the rate of GDP growth, inflation, exchange rate, among others.

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<sup>5</sup> See, Escolano, J. (2010) “A Practical Guide to Public Debt Dynamics, Fiscal Sustainability, and Cyclical Adjustment of Budgetary Aggregates,” IMF Technical Note and Manual No. 2010/02 (Washington: International Monetary Fund).

For analysis in this OPP the basic macroeconomic assumptions for Greece were taken from the most recent projections by the IMF.<sup>6</sup> These include projections for GDP growth, GDP deflator, Core Price Index (CPI), general government revenues, general government expenditures, general government primary balance and general government gross debt for the period 2014–19.<sup>7</sup> Furthermore, in order to make compatible the projections in this OPP with the projections made by the IMF, an implicit interest rate was calculated, which is equal to the difference between the projected general government fiscal balance and the general government primary fiscal balance, divided by the debt stock, as is also stated by the IMF.<sup>8</sup>

To make the analysis simpler, two further assumptions were used in the model. First, it was assumed that the entire public debt of Greece is denominated in Euros. This is a fairly safe assumption given that prior to the debt restructuring that took place in 2012 only 1.9% of the debt was denominated in currencies other than the Euro.<sup>9</sup> Second, given the lack of a detailed schedule for the privatisation programme that is currently implemented in Greece, and given the considerable uncertainty surrounding any estimate of privatisation returns, the model assumes no further privatisations will take place.<sup>10</sup> The key results are not significantly affected by this assumption, while the analysis becomes less hypothetical. Moreover, the view that the sale of public assets in a depressed economy can be expected to alleviate the debt problem has been generally questioned.<sup>11</sup>

Based on these assumptions, a baseline scenario for the evolution of the ratio of gross public debt to GDP was projected, which we have called the RMF baseline. Figure 1 shows the comparison between the RMF baseline and the current IMF baseline. In both scenarios, general government gross debt is projected to peak in 2014 and to follow a downward trend to the end of the decade. According to the projections of the IMF, Greek debt will amount to 138% of GDP in 2019. In the RMF baseline scenario, Greek debt will stand at 147% of GDP for the same year. The difference between the two scenarios is due to the exclusion of privatisation receipts from the RMF baseline scenario. This highlights the important role played by the highly uncertain privatisation returns in the strategy of debt reduction followed by the Troika. For the purposes of this OPP it was judged safer to avoid including privatisation returns.

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<sup>6</sup> See, World Economic Outlook Database (April 2014) available at: <http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx>

<sup>7</sup> The general government encompasses the central government, state governments, local governments as well as social funds.

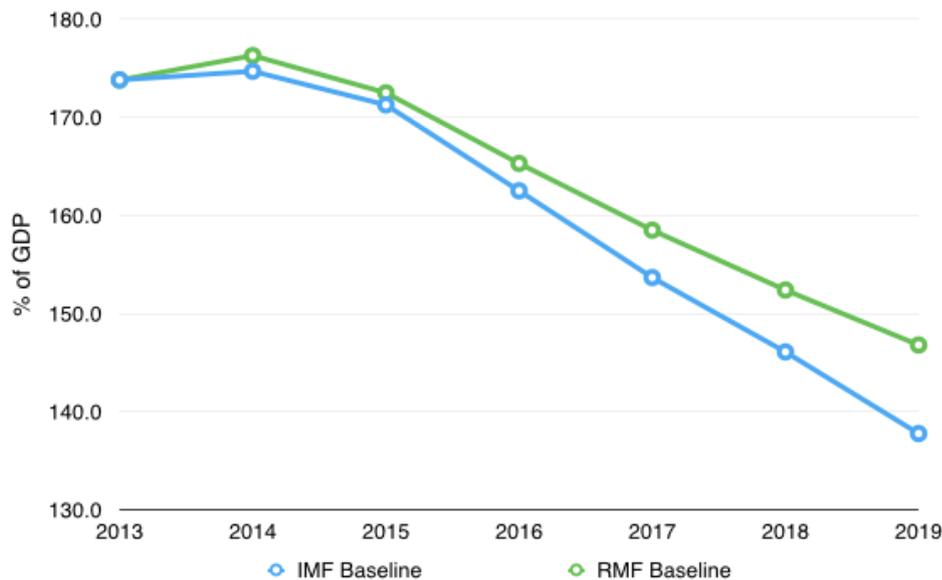
<sup>8</sup> The difference between the total fiscal balance and the primary fiscal balance is equal to interest payments.

<sup>9</sup> See, Zettelmeyer, J., Trebesch, C., Gulati, M., (2012) "The Greek Debt Exchange: An Autopsy", draft copy available at: <http://av.rftdata.co.uk/files/2012/09/The-Greek-Debt-Exchange-An-Autopsy.pdf>

<sup>10</sup> Privatisation receipts make an important component of the policy agenda implemented by the Troika in order to reduce public debt in Greece. The official goal for privatisation receipts amounts to 24 billion euros between 2014 and 2020, see, "Greece to meet 2013 asset sales target, upbeat on 2014 plan: privatization chief", available at: <http://www.reuters.com/article/2013/12/16/us-greece-privatisation-idUSBRE9BF0Y920131216>

<sup>11</sup> See, Manesse, P., (2014) "Privatizations and Debt: Lessons From The Greek Fiasco" available at: [http://www.economonitor.com/blog/2014/01/privatizations-and-debt-lessons-from-the-greek-fiasco/?utm\\_source=feedly#sthash.rKIXSznn.dpuf](http://www.economonitor.com/blog/2014/01/privatizations-and-debt-lessons-from-the-greek-fiasco/?utm_source=feedly#sthash.rKIXSznn.dpuf)

Figure 1 - Gross Debt as % of GDP; General Government; Greece



Source: IMF (2014) World Economic Outlook; projections made by the authors.

Given the two baseline scenarios, the following two sections analyse the implications of, respectively, the ‘soft’ and the ‘hard’ option regarding Greek public debt. Section 3 focuses on the ‘soft’ option of, effectively, reducing the interest rate on Greek debt.

#### 4. The “soft” option: Increased maturity and reduced interest rates

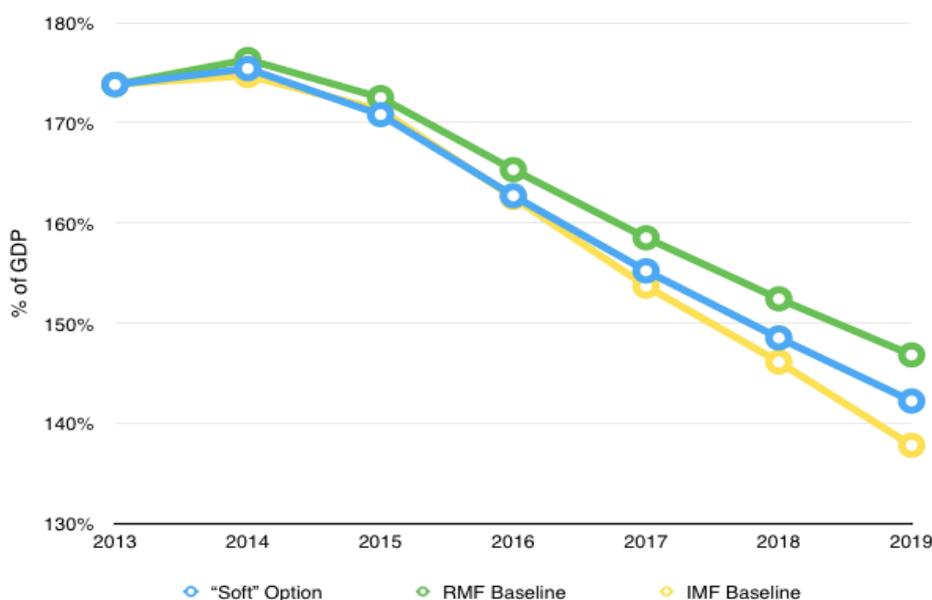
There is widespread, if implicit, understanding of the need to undertake further action regarding the long-term sustainability of Greek debt, given the highly negative effects of austerity policies on the Greek economy. The latest proposal, apparently promoted by the Greek government and to be discussed by public officials between May and June of 2014, is to increase the maturity of official loans to 50 years and to reduce the rate of interest by up to 50 basis points.<sup>12</sup>

If accepted, this proposal would have two different impacts on the framework for fiscal policy in Greece. First, an increase in maturity would reduce the net borrowing requirements of the

<sup>12</sup> See, “EU Said to Weigh Extending Greek Loans to 50 Years” available at: <http://www.bloomberg.com/news/2014-02-05/eu-said-to-weigh-extending-greek-loans-to-50-years.html>

country. This would relax the constraints in terms of debt issuance but it would not have any impact on the fiscal constraints faced by Greece.<sup>13</sup> Second, a reduction of the interest rate would accelerate the rate of debt reduction, even without any changes in the baseline primary balance targets.

Figure 2 - Gross Debt as % of GDP; General Government; Greece



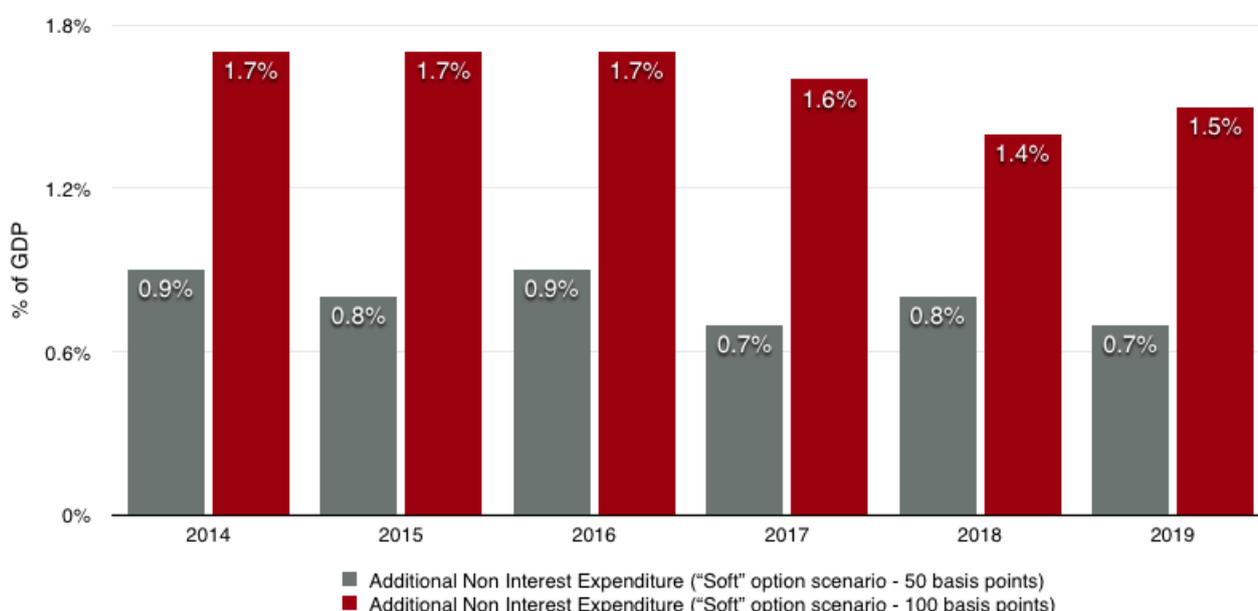
Source: IMF (2014) World Economic Outlook; projections of the authors.

Figure 2 shows the impact of the “soft” option on the evolution of gross public debt of Greece. It assumes that there is a reduction of 50 basis points in the implicit interest rate from 2014 to 2019. This is more generous than 50 basis points reduction in just EU debt but it still allows for comparison. It can be clearly seen that the effect of a reduction in interest rates on the evolution of public debt would be marginal at best: the debt to GDP ratio would stand at 142% by 2019. This represents an improvement of barely 5% with respect to the RMF baseline scenario. The weak improvement can be explained by the fact that the debt restructuring that took place in 2012 has already had a significant impact in reducing the interest rate on Greek debt. On this basis it was estimated that for the 2014–19 the implicit interest rate on Greek debt will average 3.2%. A further reduction of 50 basis points from that already low level would not have a significant impact either on the debt ratio of Greece.

<sup>13</sup> According to the IMF Government Finance Statistics Manual of 2001 amortization payments are to be treated as part of the operations required for the financing of a government under the category of transactions in financial assets and liabilities. As such they are not taken into account in the calculation of the primary balance. This is why an increase in the maturity of the loans, while reducing the net borrowing requirements, would not have any impact on the fiscal balance of the government. From the perspective of fiscal policy, and for the purposes of this OPP, interest payments represent the main variable that needs to be examined.

The conclusion that the ‘soft’ option would be ineffectual is further reinforced by Figure 3, which shows the fiscal space that would be available to Greece, if the savings generated by the putative interest rate reduction were used to relax the implementation of austerity measures. The assumed increase in non-interest expenditures would be consistent with a return to the RMF baseline scenario of debt to GDP ratio. In other words, the primary balance targets would be relaxed to provide space for a stimulus policy, without a change in the overall strategy of debt reduction. Figure 3 shows the impact of both a 50 and a 100 basis points reduction. The former would on average open up a fiscal space equivalent to 0.8% of GDP per year; the latter would create a fiscal space averaging 1.6% of GDP.

Figure 3 – Additional fiscal space associated with the “soft” option – General Government Non-Interest Expenditure as a % of GDP

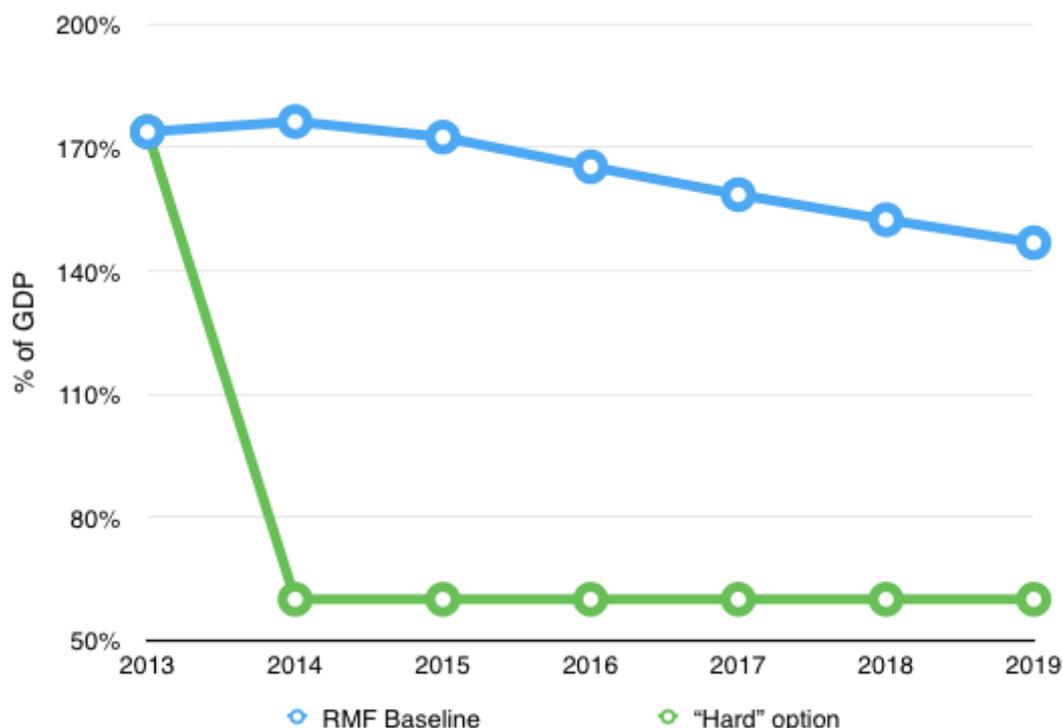


Source: Projections by the authors.

### 5. The “hard” option: Debt write-off

An alternative option available to Greece would be to write-off a large part of its debt with the objective of drastically reducing the ratio of debt to GDP. For the purposes of this OPP it will be assumed that the target would be to reduce debt to the level of 60% of GDP in accordance with the Maastricht criteria. This would be a very deep reduction, of the order of 200bn EUR, and it would undoubtedly have serious political and other implications, which cannot be analysed here. What matters for our purposes is to measure the impact of the write-off for the fiscal space available to the country, allowing it to implement alternative economic policies that would put an end to austerity and economic depression.

Figure 4 - Gross Debt as % of GDP; General Government; Greece



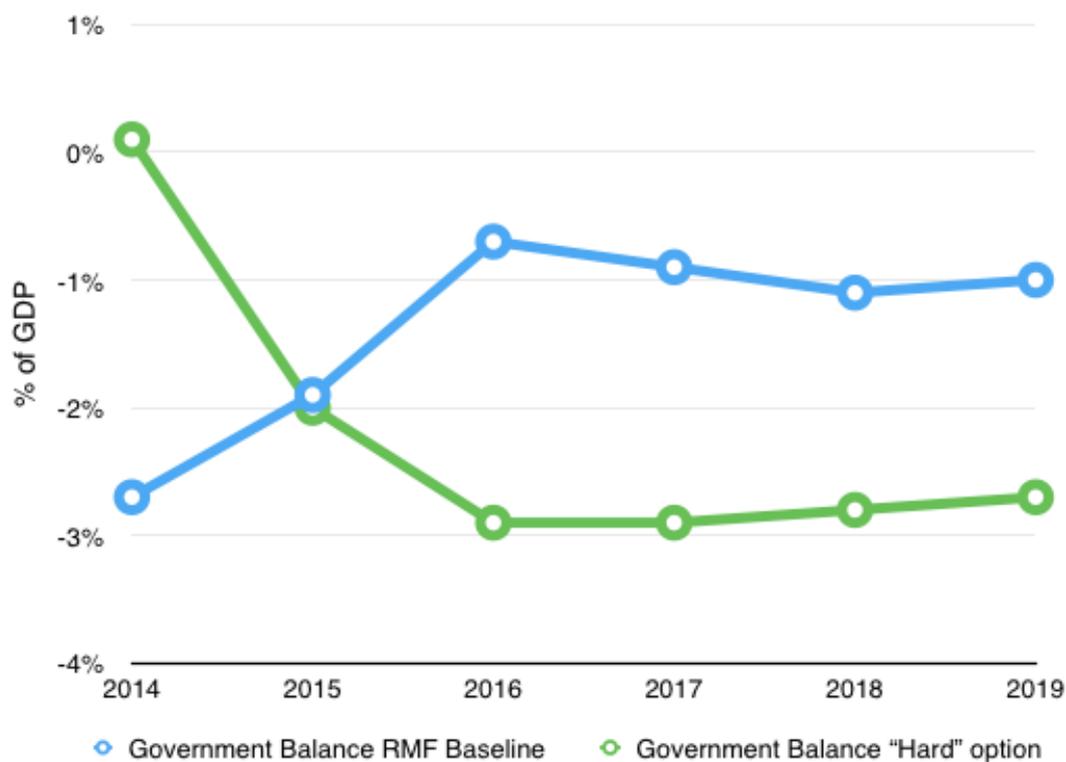
Source: Projections by the authors.

Figure 4 shows the projected evolution of gross public debt comparing the RMF baseline scenario with a debt write-off scenario. To be more specific, the write-off scenario assumes that, after the write-off, fiscal policy continues to conform to the Maastricht criteria: government deficit would remain under 3% of GDP and debt would be stabilised at a ratio of 60% of GDP (shown in Figure 5). It also assumes that the government would be able to finance a primary balance deficit of 0.7% per year for 2015-2019;<sup>14</sup> finally, it is assumed that interest rates would remain stable.<sup>15</sup>

<sup>14</sup> The primary balance refers to difference between revenues and expenditures, excluding interest payments. A primary deficit, therefore, implies the need for additional resources, either through grants or borrowing, to finance the current level of expenditures. Given that in the initial stages of a sovereign default a country might find it difficult to obtain such additional financing, the primary balance becomes an additional constraint on fiscal policy. For methodological purposes, this OPP only uses the Maastricht criteria as the overriding constraint on fiscal policy. If the further constraint were to be included the fiscal space associated to the hard option would decrease by 0.7% of GDP per year.

<sup>15</sup> In the short term a sovereign default implies a temporary exclusion from market funding. Nonetheless there is little empirical evidence showing that such exclusion would last for an extended period of time. Furthermore, as the fiscal position of a country would improve after the default, creditors would be more, not less, inclined to lend. This would also result in the stabilization or reduction of interest rates. See, Stiglitz, J. (2010) "Sovereign Debt: Notes on Theoretical

Figure 5 – General Government Fiscal Balance - % of GDP

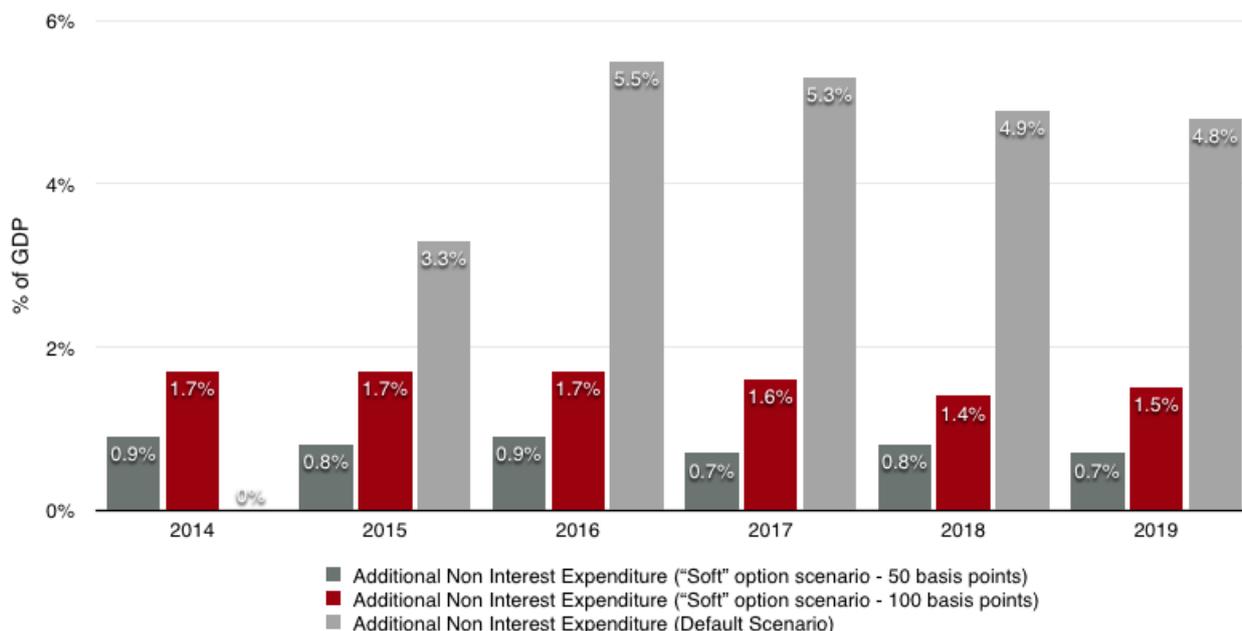


Source: IMF (2014) World Economic Outlook; projections by the authors.

As it is shown in Figure 6, the deep reduction in the debt burden of Greece through the ‘hard’ option would create a unique opportunity for a dramatic change in the fiscal framework, thus improving the general economic conditions of the country. Compared to the RMF baseline scenario, the ‘hard’ option would allow the government of Greece to increase non-interest expenditures by an average of 4.8% for the period between 2015 and 2019. This would be equal to an average of 9.9bn EUR per year, which would become available to fund public investment, salaries and pensions, and a host of welfare expenditures. The amount is roughly six times the magnitude of fiscal space that could be achieved through a 50 basis points reduction on the average interest rate along the lines currently discussed by the Greek government and the EU. It is also more than three times the space that would be created by – the much less likely – reduction of interest rates by 100 basis points.

Frameworks and Policy Analyses” in *Overcoming Developing Country Debt Crises*, B. Herman, J.A. Ocampo, and S. Spiegel, eds., Oxford, Oxford University Press.

Figure 6 - Additional fiscal space associated with a “soft” and a “hard” option – General Government Non-Interest Expenditure as % of GDP<sup>16</sup>



Source: Projections by the authors.

To sum up, analysis in this OPP has shown that a deep debt write-off is the best option available to Greece, if it wishes to gain room to implement fiscal policies that support growth as well as ensuring debt sustainability. Needless to say there would be significant political and institutional complications attached to this option which merit separate analysis; suffice it to make a few relevant observations here. Public debt is a contractual obligation which, in the case of Greece, is largely governed by English law. To write it off it would be necessary to have the agreement of both lender and borrower, something that could emerge only after a process of negotiation. The real problem for Greece, therefore, is to establish the basic parameters of the negotiation, something that could be done only through open debate, which has never happened in the country.

<sup>16</sup> Note that in the case of the “soft” option, fiscal space is defined as the additional non-interest expenditure - compared to the baseline scenario - that would return the debt to GDP ratio to its trend according to the RMF baseline. In the case of the “hard” option, fiscal space is defined as the additional non-interest expenditure - compared to the baseline scenario - that would stabilize the debt to GDP ratio at 60%.

The position of Greece has, of course, been considerably weakened since 2010, because the debt is now mostly official and governed by English law, but that does not mean that a determined government with solid popular support would not be able to find powerful political arguments, given the current state of the European Union. To strengthen its hand Greece ought to approach the negotiations in a sovereign and democratic manner. That is, it must have a well-specified position expressed as the demand of a sovereign state; it must also arrive at this position through a process of democratic accountability, including a public audit, that would throw open the books of public debt. These would be vital elements in establishing the moral and political authority that the country would need to achieve the large write off that it requires.

Ultimately, however, and if success in initial negotiations proves elusive, Greece would have only one significant weapon in its armoury, namely a unilateral sovereign default. Clearly, this would be a major act that could be expected to result in a forceful response by the lenders, perhaps including legal proceedings. It is imperative, therefore, for a Greek government aiming for a deep write off to be well prepared for an eventuality of this nature, both economically and politically. Greece has been ravaged by the depression of the last six years, but at least it no longer has the massive fiscal and current account deficits of 2009. There are advantages that could be mobilised to strengthen its hand.

Finally, the undoubted difficulties of the 'hard' option pale into insignificance when compared to the implications (and delusions) of the current policy framework. The RMF baseline scenario indicates that, under current policies, Greece would reach the threshold of 60% of debt to GDP in 26 years! Effectively, the country would have to have austerity measures of one type or another for decades. This is clearly untenable for any democratic polity. The time is fast approaching when Greece will have to choose between the disastrous current policies and the tough but promising alternative. It urgently needs to have a public debate on how far it wishes to go in achieving the write off that its economy desperately needs.