On Structural Reforms and Debt Relief

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The recent trip of the Greek Prime Minister to the US was dominated by repeated calls for debt relief. The Greek pile of debt, currently at 177% of the country's GDP, is undoubtedly high (see here for a recent analysis on the sustainability of the Greek debt). In July 2015, the IMF (one of Greece's so-called Troika partners) produced a sustainability report which raised the issue of extending Greek debt maturity. Indeed, a possible way forward for debt relief involves pushing Greece's average debt maturity, currently at 16.5 years (see also here and here) further into the future. In its July 2015 report, the IMF also raised the issue of "voluntary" haircut in the debt holdings of Greece's Eurozone partners. The Greek PM Speaking in September 2015 to *The Wall Street Journal* (here) argued that a possible Greek debt restructuring will almost immediately be followed by access to international financial markets. This, however, is not certain since getting access to financial markets works through the credit scores assigned by credit rating agencies.

Let us expand on this issue. We focus on *Moody's Investor Services* because academic research has shown that investors value "more" decisions made by *Moody's* rather than decisions made by *Standard&Poor's* (see Livingston *et al*, 2010). Faced with a Caa3 credit rating by *Moody's*, Greece needs an upgrade of 9 notches to "escape" the so-called junk territory. Using the empirical model discussed in Boumparis *et al* (2015), we estimate that a deep front "voluntary" haircut of as many as 40 percentage points in the debt-to-GDP ratio (that is, from the current 177% to 137%) will raise Greece's credit rating by only 3 notches. On the other hand, if Greece manages to "switch" from an estimated (by the IMF) 2.3% recession in 2015 (see here) to (anaemic) growth of 0.5% in 2016, it will "earn" less than half a notch upgrade. Clearly, these credit upgrades are too few to take Greece out of the junk territory. Nevertheless, combined with a swift improvement in regulatory quality, which has the potential of raising Greece's credit rating by some 6 notches, Greece can exit the junk territory sooner than later.

Needless to say, Greece needs an improvement in regulatory quality. To understand this, one can look at the latest data on World Bank's regulatory quality index (here). The index captures perceptions of the ability of the government to formulate and implement sound policies that promote private sector development. Among 215 countries, the index currently ranks Greece at the 65th percentile. According to our model calculations, an advance to the 68th percentile has indeed the potential of earning Greece an upgrade by up to 6 notches. Even in this scenario, however, Greece will remain behind other peripheral countries. For instance, both Spain and Portugal are currently ranked higher at the 75th percentile. Ireland is ranked much higher at the 95th percentile.

With Greece falling behind other peripheral countries in terms of regulatory quality, it makes sense for Greek government to proceed swiftly with structural reforms before even contemplating a return to the financial markets. This has to be done at the same time with the calls for debt relief.

References

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