The IMF's Preliminary Draft Debt Sustainability Analysis: what does it mean?

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By Vassilis Monastiriotis

The release of the latest analysis by the IMF on the sustainability of the Greek debt, which states loudly that Greece will need not only a hefty new bailout but also a further debt restructuring, fueled again the literature, in traditional and social media, about the motives behind the insistence of the European institutions on continuing austerity. On a surface reading, the message is clear: if the debt is unsustainable, we either cut it or let Greece default; but we cannot expect the debt to become sustainable by imposing further austerity to Greece. Posts in social media proliferated, arguing that "the IMF knew this all along", that "this shows how the Germans simply want to crush the Greek economy and society", and how this is an admission that the debt-forgiveness arguments by Greece's anti-austerity government are in reality accepted even by "its enemies". [Incidentally, my friend Yiannis (with two 'n') has been telling me this for years now, well before the IMF finally 'admitted' to it.]

I am going to claim that this is really and truly the wrong way to read the IMF report. For various reasons, I would say, but my focus here is on the following: because it misunderstands the **economics of debt sustainability**, the **politics of the IMF**, and the **political economy of bailouts**.

The economics of debt sustainability. Despite the 'orthodoxy' that was temporarily created by the now infamous work of Reinhart and Rogoff, there is no "natural" or otherwise "optimal" level of debt. As is well known to anybody who has ever studied any international economics, debt sustainability depends on the balance between the rate at which your economy grows (which, to be more specific, comprises real productivity growth, employment growth and inflation) and the interest rate you are charged for the debt you owe. If these are equal, your debt will remain constant (as a share of GDP) for as long as you don't produce new debts (i.e., if you don't run primary deficits). If interest rates are higher than your growth rate, then the debt will keep rising even if you have a balanced budget. Which goes to say that whether your debt is sustainable (first case) or not (second case), has very little to do with the size of the debt. [It is of course true that the level of the debt, and of the primary deficit, will have an impact on interest rates; while the adjustment to the primary balance will have an impact on the rate of growth. But, as I have shown elsewhere, more important for growth and interest rates, and thus ultimately for debt sustainability, are aspects that have to do with the structure of the economy and the quality of governance – i.e., specifically aspects that are meant to be addressed by structural reforms. This is why, often, fiscal adjustment programmes also contain deregulation and institution-building measures that extend well beyond the realm of fiscal policy. Other factors, including the maturity outlook of the debt and the resulting 'gross financing needs' also play a role – but these concern issues of liquidity, not of solvency.] The IMF knows this, of course – have no doubt about this. So why are they talking now about an "unsustainable debt"???

Enter the politics of the IMF. The IMF (which, incidentally, *is* a democratic institution, in the sense that its executive is accountable to its general assembly and in the sense that all its officials are appointed to represent the elected governments of the states that constitute its membership) has this 'strange' rule, that they are only allowed to lend money to countries which are *solvent*, i.e., ones that have sustainable debts but experience temporary financing problems (also known as liquidity problems). Which means that, for the IMF to get involved, they have to find a way to claim that the country they are bailing out has a liquidity, but not a solvency, problem – in IMF jargon, the debt has to have a "high probability" of being sustainable. When the Greek crisis erupted, the IMF knew of course that Greece had more than a liquidity problem and they didn't want to be involved. But the Europeans (Germans) wouldn't agree to a "European" bailout, because this was against EMU rules. So, getting the IMF involved was solving 'with one stone' two major problems: (a) the problem of capacity and legitimacy, by piggybacking on the knowhow and credibility of the IMF; and (b) the problem of the rules of EMU, by 'dressing' the Eurozone bailout as an international bailout which was beyond EMU rules. So, the IMF had to invent an argument that said that the Greek debt was sustainable. They amended their 'exceptional access' criterion on the premise that the Greek crisis carried a 'systemic risk', which allowed them to provide assistance even if the Greek debt was not deemed to be "sustainable with high probability". Still, and exactly because of the debt sustainability formula (see the previous paragraph), the IMF had no clear definition of what constitutes a "sustainable debt" – they always do a "sustainability analysis" but, unlike Rogoff or Maastricht, they never assign a specific number to what is sustainable and what is not. Unfortunately for Greece, the Eurozone had a numeric definition of sustainability (60%) and Rogoff had just published a book and two American Economic Review articles which "proved" that the sustainability threshold was at 90%. So the IMF started working the numbers backwards, trying to figure out what types of growth rates and what types of fiscal multipliers would produce a "sustainable" debt. [Do I know this for a fact? No. Is it consistent with things I know? Absolutely yes.] At the end, they had to dig very hard: all they managed was to arrive at a set of measures that would seem to stabilise the country's "gross financing needs" (GFN) to 10% of GDP, which incidentally produced a debt level of 120% by 2020 (60, 90, 120: you can see where this is coming from) – and this, only after assuming a seriously underestimated multiplier (0.5), a very ambitious long-run growth rate (4%), and a beyond-imagination sum of proceeds from privatisation (€50bn). So, they baptised the Greek debt as sustainable, on the premise that it would be reduced to 120% in the space of ten years. [We all know of course that IMF's Chief Economist, Oliver Blanchard, later 'admitted' that their assumed multiplier was too low and that the IMF had made a 'mistake' in this. Perhaps.] After 5 years of adjustment programmes (and a Greek default on IMF debt), it seems that the IMF have had enough – and they want out. They have no faith any longer in Greece implementing serious, speedy and effective reforms, or fiscal consolidation (they say this openly in the report: "given persistent underperformance"), so they produced their new analysis to show that the debt – although still shown to be declining, and in this sense sustainable – will not go below 130% for the foreseeable future (although they still say that this is unless "Greek policies […] come back on track"). Using, on this basis, their previously set GFN target of 10% of GDP (and deciding that the 'systemic risk' amendment does not apply anymore), they can claim that the debt is not "sustainable with high probability", implying that they will only continue to be involved in a rescue deal for Greece if the Europeans (Germans) accept a restructuring (haircut) of the Greek debt. To put it differently, the IMF now says: *we know that Greece will not implement fully a(ny) adjustment programme and we don't want to maintain our exposure to Greece under these conditions; so either the Europeans (Germans) take a loss and keep us on board, or we are out and let the Europeans (Germans) sort things out themselves*. But why don't the Europeans (Germans) agree on a haircut?

The political economy of bailouts. Of course, the Europeans are also aware of the debt sustainability formula. And they also understand that a(ny) debt which is declining is by definition also sustainable. So, they didn't worry that much about that 120%, about whether this would be reached in 10 years or in 20, or if the GFN figure would be at 10% or instead, as the IMF now calculates, at 11.25%. But they also understood that there was something fundamentally wrong with Greece – its ineffective institutions, its clientelistic state and its uncompetitive and over-regulated economy – and they wanted this to be fixed for good. So they pushed for harsh austerity measures and pervasive reforms, in order to mobilise change – structural change – in Greece. Driven by (their reading of) the positive experience of the Eastern transition, where their conditionality model of harsh upfront conditions (stick) and sizeable endpoint rewards (carrot) had been rather effective in mobilising change (democratisation and economic modernisation), they saw this as a "window of opportunity" for pushing for reforms in Greece. So they pushed for this as hard as they could. This was in fact handy, because in this way they were allowed to justify their apparent breach of EMU rules (non-bailout clause) and the transfer of money from their own taxpayers: *we are only doing this because the other side has committed to extensive and pervasive reforms; we are doing this because this is what the EU does – it democratises and modernises its internal and external 'neighbourhood'.* But did they believe this could work entirely and forever? No, the Europeans (Germans) also understood that the terms of austerity imposed on Greece were very harsh and they were creating a very sizeable recession. So they committed (already in November 2012) to reducing the debt, but only after Greece had entered a path of sustainability (declining debts – forget the 120%) and of modernisation (functioning institutions, effective state, competitive economy). They didn't want to offer a ‘carrot’ too early, because they knew (or, they believed) that this would render the ‘stick’ ineffective. Which all goes to say that the terms of the bailout were not decided on the basis of what was the easiest way to achieve a desired number (120%, 90%, 60% or whatever), but rather on the basis of what would be the most effective mechanism to make Greece, as the Copenhagen Criteria have it, a state with “stability of institutions … [and] … a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union”. This was not unique to this bailout agreement. Any bailout agreement, by the IMF or any other institution, comes with a specific agenda and with specific conditions: it is not a blank cheque to help “a friend in need” get out of the troubles caused by past mistakes; it is a technology for ensuring that a troubled partner will never run into troubles again.

And, so, let’s go back to the original question. What does the latest admission by the IMF, about the ‘unsustainability’ of the Greek debt, show? Does it show that Greeks (and, incidentally, Krugman) were always right, to claim that the imposed austerity was counter-productive and that the right way for dealing with the Greek crisis was debt-forgiveness (and/or restructuring)? No. [Warning: long/complex sentence follows!] It simply shows that the IMF does not trust Greece to implement the reforms that the Europeans (Germans) require in order to allow Greece to restructure some of its debt in a way that would allow a less aggressive fiscal consolidation path, so that the balance between interest rates and the growth rate inside the sustainability formula remains always in favour of the growth rate or, in other words, so that the debt continues to decline and, in this sense, becomes sustainable. Nothing more and nothing less than this. Not a vindication for the arguments of my anti-austerity Greek friends, not an admission of mistaken calculations by the ‘evil’ IMF, not a proof that the Europeans (Germans) are blind or vindictive. Simply, a case to show that the Greek problem is one where economics, politics and political economy considerations interact in mysterious and sometimes agonising ways. The fact of the matter remains: Greece will be unable to bring its economy back on track unless its “persistent underperformance” is reversed or unless somebody decides to grant Greece a multi-billion gift. We knew that all along.

***Dr Vassilis Monastiriotis** is Associate Professor in the Political Economy of South Eastern Europe at the LSE. Dr Monastiriotis’ research focuses on economic policy and performance at the regional, national and supra-national levels, with emphasis on trade, FDI and the labour market.*