A tale of two debt write-downs

By Adair Turner
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At the end of 2015, Greece's public debt was 176% of GDP, while Japan's debt ratio was 248%. Neither government will ever repay all they owe. Write-offs and monetization are inevitable, putting both countries in a sort of global vanguard. With total public and private debt worldwide at 215% of world GDP and rising, the tools on which Greece and Japan depend will almost certainly be applied elsewhere as well.

Since 2010, official discussion of Greek debt has moved fitfully from fantasy to gradually dawning reality. The rescue program for Greece launched that year assumed that a falling debt ratio could be achieved without any private debt write-offs. After a huge restructuring of privately held debt in 2011, the ratio was forecast to reach 124% by 2020, a target the International Monetary Fund believed could be achieved, "but not with high probability." Today, the IMF believes that a debt ratio of 173% is possible by 2020, but only if Greece's official European creditors grant significant further debt relief.

Greece's prospects for debt sustainability have worsened because the eurozone's authorities have refused to accept significant debt write-downs. The 2010 program committed Greece to turn a primary fiscal deficit (excluding debt service) of 5% of GDP into a 6% surplus; but the austerity needed to deliver that consolidation produced a deep recession and a rising debt ratio. Now the eurozone is demanding that Greece turn its 2015 primary deficit of 1% of GDP into a 3.5%-of-GDP surplus, and to maintain that fiscal stance for decades to come.

But, as the IMF rightly argues, that goal is wildly unrealistic, and pursuing it would prove self-defeating. If talented young Greeks must fund perpetual surpluses to repay past debts, they can literally walk away from Greece's debts by moving elsewhere in the European Union (taking tax revenues with them).

The IMF now proposes a more realistic 1.5%-of-GDP surplus, but that could put the debt ratio on a sustainable path only if combined with a significant write-down. Eurozone leaders' official stance, however, continues to rule that out; they will consider only an extension of maturities and reduced interest rates at some future date.

If pursued to the limit, such adjustments can make any debt affordable – after all, a perpetual non-interest-bearing debt imposes no burden at all – while still enabling politicians to maintain the fiction that no debt had been written off. But the maturity extensions and rate reductions granted so far have been far less than needed to ensure debt sustainability. The time has come for honesty: A significant write-down is inevitable, and the longer it is put off, the larger it eventually will be.

Greece's unresolved debt crisis still poses financial stability risks, but its $340 billion public debt is dwarfed by Japan's $10 trillion. And while most Greek debt is now owed to official institutions, Japanese government bonds are held in private investment portfolios around the world. In Japan's case, however, debt monetization, not an explicit write-off, will pave the path back to sustainability.

As with Greece, official fiscal forecasts for Japan have been fantasies. In 2010, the IMF described how Japan could reduce net debt (excluding government bonds held by quasi-government organizations) to a "sustainable" 80% of GDP by 2030, if it turned that year's primary fiscal deficit of 6.5% of GDP into a 6.4%-of-GDP surplus by 2020, and maintained that surplus throughout the subsequent decade.

But virtually no progress toward this goal had been achieved by 2014. Instead, the new scenario foresaw that year's 6%-of-GDP deficit swinging to a 5.6% surplus by 2020. In fact, fiscal tightening on anything like this scale would produce a deep recession, increasing the debt ratio.

The Japanese government has therefore abandoned its plan for an increase in sales tax in 2017, and the IMF has ceased publishing any scenario in which the debt ratio falls to some defined "sustainable" level. Its latest forecasts suggest a 2020 primary deficit still above 3% of GDP.

But the debt owed by the Japanese government to private investors is in free fall. Of Japan's net debt of 130% of GDP, about half (66% of GDP) is owed to the Bank of Japan, which the government in turn owns. And with the BOJ buying government debt at a rate of ¥80 trillion ($746 billion) per year, while the government issues less than ¥40 trillion per year, the net debt of the Japanese consolidated public sector will fall to 28% of GDP by the end of 2018, and could reach zero sometime in the early 2020s.

The current official fiction, however, is that all the debt will eventually be resold to the private sector, becoming again a real public liability which must be repaid out of future fiscal surpluses. And if Japanese companies and households believe this fiction, they should rationally respond by saving to pay future taxes, thereby offsetting the stimulative effect of today's fiscal deficits.

Realism would be a better basis for policy, converting some of the BOJ's holdings of government bonds into a perpetual non-interest-bearing loan to the government. Tight constraints on the quantity of such monetization would be essential, but the alternative is not no monetization; it is undisciplined *de facto* monetization, accompanied by denials that any monetization is taking place.

In both Greece and Japan, excessive debts will be reduced by means previously regarded as unthinkable. It would have been far better if debts had never been allowed to grow to excess, if Greece had not joined the eurozone on fraudulent terms, and if Japan had deployed sufficiently aggressive policy to stimulate growth and inflation 20 years ago. Throughout the world, radically different policies are needed to enable economies to grow without the excessive private debt creation that occurred before 2008. But having allowed excessive debt to mount, sensible policy design must start from the recognition that many debts, both public and private, simply cannot be repaid.

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