Money Supply

Should the troika have 'gambled for redemption'?

Claire Jones Oct 20 2011 19:16 2

The FT's Peter Spiegel reports today of a standoff between the ECB and the IMF over how swingeing the next round of Greek cuts should be.

> *Part of the reason for the delay is a standoff between two of the members of the troika – the IMF and ECB – over whether Greece can keep paying its debts without taking more stringent austerity measures. The ECB has taken a tougher line, while the IMF has urged more leniency.*

Which is right? According to a paper to be presented at a St Louis Fed conference tomorrow, the ECB is when it comes to Greece. But the case is far less clear cut on whether the troika should push for such harsh cuts elsewhere.

For economists Juan Carlos Conesa and Timothy Kehoe, what puts countries most at risk of suffering what they label a "self-fulfilling debt crisis" – for which there is no option but default – is the sharp drop in revenues that occurs as a result of recession.

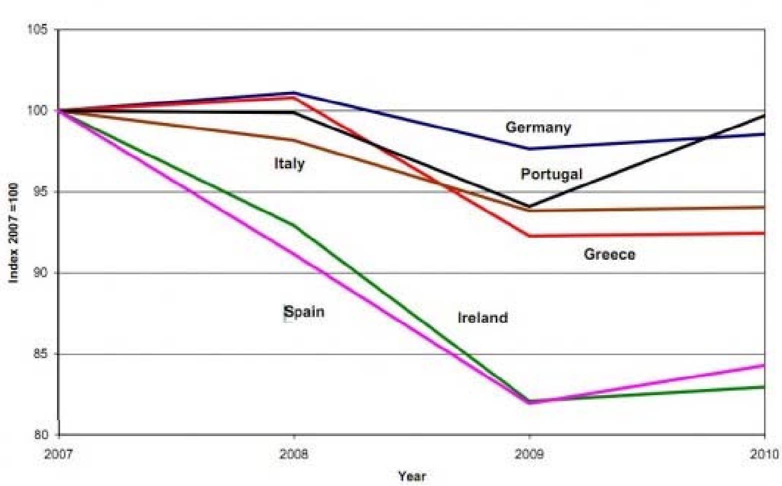
Because of this, the research argues that – *in some instances* – it is better for governments to "gamble for redemption", ie, avoid cuts and hope for a recovery in revenues to ease their debt burdens.

For European sovereigns, who tend to borrow at longer maturities, the point at which it's no longer wise to gamble is when the debt-to-GDP ratio exceeds 130 per cent. Greece's debt totalled 142.8 per cent of output last year. And with the troika now expecting it to balloon from an earlier estimate of 161 per cent to 180 per cent of output next year, the troika has little choice but to push Athens to cut more.

If the cut-off point of 130 per cent is accurate, then it's too late for Greece to avoid austerity. But there are lessons here for other eurozone sovereigns too.

As the chart below shows, it is not just Athens that has seen the sort of sharp dip in revenues that the economists believe could trigger the sort of debt crisis that ends in default.

Figure 3: Real government revenues in selected European countries



However, in 2010, all had debt-to-GDP ratios of less than 130 per cent. Perhaps the troika should consider a little more lenience when it comes to other austerity packages.

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