

THE LAST WORD

Last updated: December 18, 2011 3:39 am

Financial tricks to get out of debt

By James Mackintosh

Something funny has been going on in Greek debt markets. Even as the yields available on bonds maturing in just a few months have soared to silly levels, the government has been able to raise money at perfectly reasonable rates.

Last Tuesday, for example, Greece issued a bill – a short-dated debt instrument – that matures in June. It raised €3.7bn (\$4.8bn), paying 4.95 per cent, annualised. By the standards of ordinary times this would be a disaster; Germany is paying zero interest on similar bills.

But given what is going on in Greece, the auction was not far short of miraculous. Rather than buying the bill from Greece, investors could have bought Greek government bonds in the secondary market maturing just five days later. At the time of the auction these bonds yielded more than 130 per cent, annualised.

Greece's ability to tap the "market" is a straightforward case of financial repression, where governments use their sovereign powers to finance themselves at below fair market rates.

What is going on in Greece is a reworked version of the old principle of printing money to pay government debt ("monetising" it), this time via the banks. Such tricks are likely to become increasingly common as governments grapple with horrific debts.

Another example is shown by the manipulation of interest rates by the US Federal Reserve. No, I don't mean quantitative easing. Back in 1951, the Fed minutes record central bankers discussing to what extent they should help the White House fund its growing deficit, what limit to set on long-term interest rates, and how much debt they should monetise.

Go back to Greece. It is able to issue bills at such low yields by manipulating the banks – bankrupt without the help of the central bank, they have little choice but to do what it wants – and by ignoring the legal terms of its bonds. Greek bills and bonds should have equal status in the "voluntary" default being negotiated with European banks. But Greece has ruled that bills will not be subject to the losses being discussed for the bonds. The European Central Bank, perhaps the biggest holder of Greek debt, will also be excluded from losses, even as Europe's commercial banks are pressured by their governments to take part.

All of this manipulation amounts to different forms of taxation, often well-hidden. The bill issues are a

tax on Greece's savers, who could have earned far more if their bank bought similar-maturity bonds. Likewise, the Fed's actions back in 1951 were a tax on bond buyers, who earned less than they would have done without Fed manipulation.

Greece's "voluntary" default is rather similar to what the Treasury went on to do when the Fed found it could no longer keep yields depressed.

The US decided to swap marketable 21-year debt paying 2½ per cent for non-marketable 29-year debt paying 2¾ per cent. That might not sound very appealing, but William McChesney Martin, then assistant secretary of the Treasury, was clear about why people would take it up. It was, he told the Fed in private, a "trick" to "lock up as much as possible" of the longer-dated paper.

Greece's trick has been seen through by creditors, who are worried about the precedent it is setting for future European defaults to manipulate bondholders' contractual rights.

But creditors are clearly not prepared for the sort of tricks governments got up to last time their debt was out of control, after the second world war.

As academics Carmen Reinhart and Belén Sbrancia pointed out earlier this year, financial repression works in two ways. It can restrict interest rates directly, as many countries did until the 1980s, and China still does, or restrict where money goes, with exchange controls and financial regulation.

Money is still free to flow across borders, but the other forms of financial repression they document are on the way back.

Already banks are being forced to jack up their holdings of government bonds, thanks to new rules designed to make them safer. Banks in the eurozone would certainly be safer if they held fewer government bonds, not more, but liquidity and capital requirements both push them to hold more. American banks now hold \$1.7tn of American government-backed bonds, up more than a third in three years.

Negative interest rates are perhaps the biggest threat. If rates can be kept down, even as inflation rises, this acts as a tax on savers, benefiting borrowers – particularly the government.

Reinhart and Sbrancia estimated this hidden "tax" was equivalent to raising tax revenues by more than a quarter from 1945 to 1980 in the UK, and by 19 per cent in the US.

Italy "raised" more by wiping out government debt in this way than it managed to secure from proper taxes between 1945 and 1970. In Britain real interest rates are minus 4.7 per cent, and in September were at their lowest since 1977. The funny goings-on are not only in Greece.

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