Greece through the rear-view mirror

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Thursday's EU summit in Brussels announced new plans for tackling the Eurozone crisis. This column says that the agreement reached on a new financing package for Greece, including some debt relief, will not reduce Greece's debt to sustainable levels. It suggests additional financial support contingent on larger haircuts.

European officials have struggled for weeks to reconcile the competing priorities of Germany and other surplus countries with those of Greece. Until Thursday's summit, the EU treated the debt crisis as a liquidity problem rather than a solvency problem. This contributed to the market turbulence and allowed the crisis to spread to Italy. This undermined confidence and threatened the stability of the euro itself.

Recognising that "re-profiling" of the debt by pushing maturities into the future is no longer sufficient, EU leaders reached an agreement that tries to address medium-term debt sustainability concerns while keeping the resulting losses for banks manageable.

The deal is probably not enough

The deal implies a 21% reduction in the net present value of debt owed to bondholders, which constitutes about 70% of Greece's total public debt. This implies a reduction of 15% in total public debt, which would bring it down from 156% to 132% of GDP. With most analysts estimating the needed debt reduction closer to 50%, this deal is unlikely to ensure debt sustainability even if Greece fully implements the medium-term fiscal plan it has just voted into law.

Since it is impossible to have a fully voluntary scheme that shifts part of the financing burden to bondholders while keeping Greece's funding costs at sustainable levels, Greece will almost certainly get a "selective default" rating. Such a rating would complicate Greece's access to ECB financing without ensuring that Greece will emerge from default with a sustainable debt burden.

Analogies with Argentina

The situation confronting Greece today is similar to Argentina's situation in the summer of 2001. The economy was in recession and credit spreads had widened as market participants realised that fiscal tightening was becoming less palatable economically and politically.

At the request of the Argentine government, which still wanted to avoid what would have been considered a selective default by the rating agencies, the IMF proceeded with a substantial augmentation of the financial support already committed under the existing three-year stand-by agreement. Argentina thus missed the opportunity to restructure its debt while it still had ample reserves and bank deposits remained near peak levels.

With the benefit of hindsight, the financial resources of the international community used to bail out private creditors should instead have been used to deal with the consequences of an orderly debt restructuring, including the provision of ample liquidity and capital to the banking system.

Greek choices

Greece is facing the same choices now. With Greece's dim prospects for market re-access in 2012-13, the EU/IMF-supported programme has been augmented with new EU resources, with more to come from the IMF, to make up for the shortfall in private financing.

But this additional financial support is likely to be wasted on what is a lost cause. The sustainability of public finances remains in doubt, as evidenced by the still-wide credit spreads (wider than in Argentina a month before it defaulted) and the large withdrawals of bank deposits, which continue even after the approval of the medium-term fiscal plan by parliament in early July. In view of the above, IMF participation in the financing of a new programme for Greece should be conditioned on a debt restructuring involving a significant haircut.

A lasting solution: Debt buyback at market prices

A lasting solution to the Eurozone's debt crisis would call for the European Financial Stability Facility (EFSF) to issue AAA-rated bonds in exchange for the outstanding bonds of the countries that need to restructure their debt, taking as collateral their assets under privatisation. Greece, Ireland, and Portugal could capture the discount on the debt that the markets have already reflected. The mechanism would be a massive repurchase of the old bonds at the current market price. The cost for European taxpayers will be much lower than that associated with continuation of the ongoing bailout. The most costly scenario is that of a disorderly Greek default that would have spillover effects on other countries, very similar to the contagion generated by the collapse of Lehman Brothers in the US.

The EU and the IMF should help Greece ensure that the debt restructuring will not destabilise the banking system and will not force conversion of financial assets and obligations into a new Greek currency. Otherwise a run

on the banks with large holdings of Greek debt will force “de-euroisation” in Greece in the same traumatic way that it forced “de-dollarisation” in Argentina in 2002.

The latest IMF staff report on Greece shows that public and external debt sustainability “hinges critically on full and timely implementation of fiscal, privatisation, and structural reforms [...] and the restoration of market access at reasonable terms in the post-programme period”. In cases where restoration of market access within the programme period is judged to be unrealistic, IMF rules encourage “comprehensive debt restructuring, to provide for an adequately financed programme and a viable medium-term payments profile”. It’s an idea whose time has come.