

2 February 2011

A GREEK RESTRUCTURING: WILL IT END THE EUROZONE DEBT CRISIS?

Key Points:

- Greece's situation is simply unsustainable. This year, Greece needs to find *at least* €53 billion just to avoid increasing its already massive debt. Even in a best case scenario and with the help of foreign taxpayers, Greece is set to fall short of these targets. The numbers simply do not add up and some sort of restructuring – or additional help – therefore seems inevitable.
- EU leaders are right to consider a Greek restructuring. However, the plan on the table, which will see Greece buy back its own debt using even more money from the EU/IMF bail-out funds, is unlikely to be sufficient and throws up a number of problems:
 - Since it hinges on new loans, debt is not so much removed as transformed. The plan will only reduce Greece's debt by between 2.4% and 4.2%, meaning that Greece's debt to GDP will still top around 146-147% this year (though this could be slashed further if private bondholders accept write downs), with new liabilities passed from private investors to taxpayers in other eurozone countries via the ECB. Neither will it solve Greece's long-term debt or budget deficit.
 - The new loans offered at lower interest rates along with the rescheduling of previous bailout funds effectively mean that the EU offers a country that has mismanaged its finances even more cheap money – this raises huge moral hazard concerns.
- In order for a restructuring to make the Greek economy sustainable and for investor confidence to return, Greece's debt must come down to below 100% of GDP, at least. This would require that over one-third of all Greek debt be written off, compared to the 2.4%-4.2% currently proposed.
- However, Greece's problems ultimately stem from its lack of economic competitiveness which a restructuring will not in itself solve. To address this problem, Greece effectively has three options: completely reform the economy, rely on permanent subsidies from stronger economies, or seek monetary independence, allowing for currency devaluation.

1) WHY GREECE NEEDS TO RESTRUCTURE

“The financial support will give Greece a sufficient breathing space from the pressures of the financial markets to decisively restore the sustainability of its public finances and to put the economy back on a path of sustainable growth.”

- EU Economic and Monetary Affairs Commissioner Olli Rehn, 29 April 2010¹

“There will be no restructuring of debt before the end of the year.”

- French Economy Minister Christine Lagarde, 6 January 2011²

The above quotes border on delusional. Greece's situation is simply unsustainable. At the start of this year the price of credit default swaps on Greek bonds (used to insure against the risk of default) put the chances of a Greek default at 30% over the next two years. Combining this with a higher interest rate on short term bonds and a lower one on 30 year bonds, it becomes clear that the markets expect a Greek default or restructuring in the near future, even with some of the market pressure on the eurozone easing.

Greek Funding gap 2011	
	€ bn
Primary Budget Deficit	4.95
Debt Repayments	32.5
Interest payments on debt	15.9
Total	53.35

Source: Greece PDMA.⁴

Expected Disbursement of Bailout Funds ³	
Date	€ bn
2010	31.5
2011	46.5
2012	24
2013	8
Total	110

The Greek debt to GDP ratio is forecast to reach 152% in 2011, around €341 billion, and its total deficit will be running at around 9.3% (€20.85 billion).⁵

This year, Greece needs to find at least another €53.35 billion just to remain at its current levels of debt (see table).⁶ The bail-out fund agreed by EU leaders last year is expected to pay out €46.5 billion, meaning that even with the bail-out money, Greece is still €6.85 billion short. Realistically, it cannot borrow this money on the markets, as

¹ European Commission, “Statement by Commissioner Rehn on Greece”, 29 April 2010 http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-04-29-statement-commissioner-rehn-on-greece_en.htm

² Speaking on *BBC Newsnight*, 6 January 2011: <http://www.bbc.co.uk/programmes/b00xfnc1>

³ IMF Global Financial Stability Report October 2010

⁴ Greek Public Debt Management Agency: http://www.minfin.gr/content-api/f/binaryChannel/minfin/datastore/b1/62/3a/b1623a6c1b61846f144e5337988f0d69daa6ea00/application/pdf/20101118_budget+2011_EN.pdf

⁵ EIU Country report on Greece, December 2010; All currency conversions are done using the exchange rate of \$1 = €0.7

⁶ Greek PDMA 2011 Budget projections. There is currently a wide range of estimates for the Greek funding gap, with much of the discrepancy stemming from differing estimations of the Greek primary deficit. The PDMA is on the low end of those estimates with a deficit of 2.2% of GDP, it is distinctly possible that the real figure could be closer to 4% of GDP as the EIU and Citibank have predicted.

it would be forced to pay an interest rate of around 11%, which is wholly unaffordable for the country.⁷ The money simply has to come from somewhere else. At the same time, the Greek economy is expected to shrink by 4% in 2011. The tax uptake in the country remains small and patchy with tax evasion estimated to cost the government around €20 billion a year.⁸

Crucially, recent developments in the currency markets also bode badly for Greece. In recent weeks the euro has become stronger against numerous currencies, particularly the dollar. A more expensive euro harms Greek exports (particularly the shipping industry) and the tourism sector, while also increasing the current account deficit due to increased import costs (around 2/3 exports go to non eurozone countries).

Similarly, with inflation in the euro zone at its highest point for many years, hitting 2.4% in January,⁹ there is likely to be increasing pressure on the ECB from Germany to increase interest rates. As ECB Chief Economist Jürgen Stark puts it, "We won't allow higher inflation in order to let the real level of debt of states decrease."¹⁰

Such a move, while understandable from a German point of view, would be detrimental to the Greek economy due to the high levels of private sector debt and the lack of funding available in the economy. At a time when Greece needs time to recover, increasing interest rates is the exact opposite policy to what is needed. This shows the massive tensions at work within the euro zone.

These developments, if allowed to continue, will transfer even more of the pain to the Greek population, since austerity measures and economic reforms at home will have to pick up the slack.

Greece has made considerable efforts at reform and austerity, but in light of the above figures and facts, the question is not whether Greece must restructure, but how anyone believed it would actually make it through this year without additional help.

2) WHAT IS THE OPTION PROPOSED BY EU LEADERS?

While they were slow to admit it, most EU leaders now acknowledge, at least implicitly, that Greece will not make it on its own. Options for a Greek restructuring will be discussed at an EU summit on 4 February, with leaked reports suggesting that a three pronged plan is being considered:¹¹

⁷ Greece's funding gaps run straight through the entire economy, some estimates state that the country's pension system faces €585 billion shortfall given its current liabilities, an amount twice the size of the Greek economy. <http://www.vanityfair.com/business/features/2010/10/greeks-bearing-bonds-201010?printable=true¤tPage=all>. IMF measures show the pension costs running at between 10%-12% of GDP per year for the past decade, its forecasts show this increasing to 25% by 2050. <http://www.imf.org/external/pubs/ft/scr/2006/cr0605.pdf>

⁸ Federation of Greek Industries 2009 estimation
(<http://www.nytimes.com/2010/05/02/world/europe/02evasion.html?pagewanted=1&r=1>)

⁹ Cited in *Reuters*, "Euro inflation rise reinforces rate hike view", 31 Jan 2011:
<http://www.reuters.com/article/2011/01/31/uk-markets-money-idUKTRE70U2YE20110131>

¹⁰ Cited in *Die Welt*, "Fear of Inflation", 28 Jan 2011:
<http://www.welt.de/wirtschaft/article12367597/Furcht-vor-der-Inflation.html>

¹¹ Cited in *Guardian*, "European union talks on Greek debt as IMF flies in", 30 Jan 2011:
<http://www.guardian.co.uk/business/2011/jan/30/greek-debt-crisis-imf-talks>

- Firstly, Greece would borrow €50bn from the European Financial Stability Fund (EFSF) – in addition to the €110 billion in EU/IMF funds that it already has tapped. The interest rate charged is likely to be between 4% and 5%.¹²
- Secondly, Greece would use the money from the EFSF to buy back bonds at between 65% - 75% of their nominal value from the ECB and private bondholders. The proposal suggests that Greece would stop short of entering the secondary bond market, meaning that private bondholders would have to voluntarily accept the same price as the ECB.
- Thirdly, the maturity of the existing EU/IMF bailout loans would be extended to 30 years and the interest rate decreased. Any private lenders who own more than €100 billion in Greek bonds would be asked to extend their maturity to 15 or 20 years.

3) WHAT WILL THE CURRENT PLAN SOLVE AND WHAT ARE THE RISKS?

EU leaders are right to contemplate a Greek restructuring – anything less would amount to outright denial, as we illustrate above. Now is also the time to do it, since the longer Greece waits the more costly and difficult it will become to restructure. By re-profiling its debt, Greece will be bought time, and will be given at least a bit of breathing space to begin to rebuild its finances. It could also have a calming effect on the markets, though arguably for the ‘wrong’ reasons as markets will see it as a clear sign that other governments (and therefore taxpayers) will continue to underwrite eurozone states in trouble (see below).

But the current plan comes with a number of shortcomings:

- **Does not end the debt bubble:** First, and perhaps most fundamentally, it does not punctuate either Greece’s or the eurozone’s debt bubble. Since it hinges on another loan from the EU and the IMF, debt is not really being removed but merely transformed. Decreasing the interest rates paid on the bailout and lengthening the time to pay it back – while considerably easing the pressure on Greece in the short-term – are still only stop gap measures. Europe’s debt is still being passed around.
- **Does not save Greece enough money:** As the figures above show, Greece’s debt problem is already much larger than the interest and principle payments of the bailout funds.¹³ Under the terms currently discussed, the scheme could represent a reduction of between 2.4% and 4.15% of the country’s total debt (once the funding gap of €6.85 billion has been accounted for).¹⁴ Under the current terms, Greece’s debt to GDP ratio would still top 145%-148%.¹⁵

¹² This is determined by the cost of borrowing for the EFSF from the market (3%) and the current interest rates paid on the bailout loans which Greece cannot afford (5%+)

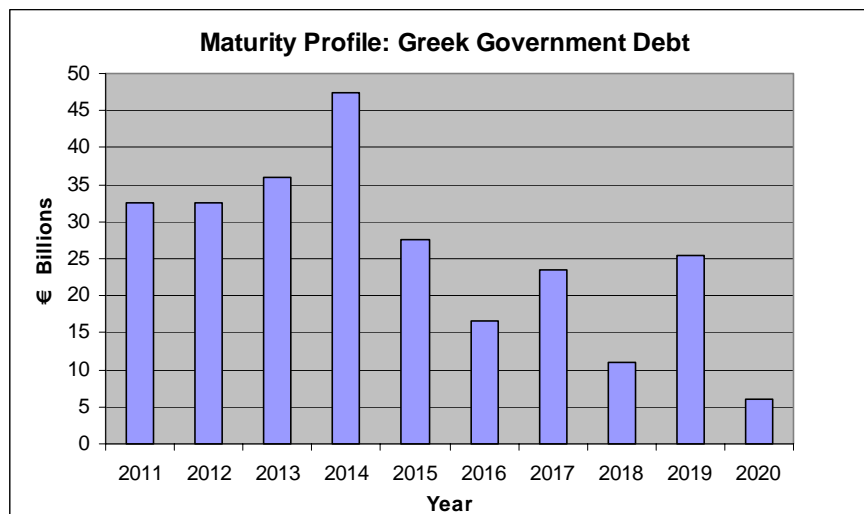
¹³ Citi Global Economics view: The Debt of Nations by Buitert et al. (p.57)

¹⁴ This is assuming that the ECB accepts write offs on all of their Greek debt. If the ECB had paid full price on these loans then it would incur a large loss. However, most reports suggest that the ECB purchased the debt at a discount, meaning they would receive more or less what it paid out. In this case the loss has already been incurred by private investors and would only be realized when the debt came back into Greek hands. There would also be savings in terms of the interest paid on the debt, as it would be replaced by the loans from the EFSF. The exact level of these savings depends on the maturity of the bonds; however, this will not change the current situation but only future costs.

Cited in *Wall Street Journal*, “Greece, EU Fund weigh debt buy back”, 28 Jan 2011:

<http://online.wsj.com/article/SB10001424052748703956604576109492911905516.html>

¹⁵ Current estimates put the ECB holding of Greek debt at around €60 billion. Therefore a write off of 25% - 35%, which is what is being discussed, would save Greece between €15 billion - €21 billion.



Source: Greek Public Debt Management Agency

It will therefore do little in itself to reduce Greece's long-term debt and budget deficit. As the graph above shows, the level of debt coming to maturity in the next decade is huge, with around €148.6 billion needing to be refinanced by the end of 2014.¹⁶ Unless the massive debt to GDP ratio is tackled and combined with strict fiscal policies Greece will be unable to return to the markets and as such will have no possibility of meeting its upcoming refinancing requirements.

- **Double moral hazard:** There is also significant moral hazard associated with a scheme such as this. The new loans offered at lower interest rates along with the rescheduling of previous bailout funds effectively mean that the EU offers a country that has mismanaged its finances an almost unending stream of cheap money. As with the bank bailouts, eurozone leaders are making a clear statement that they will never allow any eurozone country to go through an outright default, meaning that a huge incentive for other peripheral eurozone countries to run responsible fiscal policies has been removed.

The moral hazard would be exacerbated here if the ECB sells the bonds back to Greece for less than it paid, thereby incurring a de facto loss on taxpayers. It is not clear at what rate the ECB purchased its stock of Greek bonds as no information on this is published. *Handelsblatt* reported it to be around a 22% discount on average.¹⁷ If the bonds were sold back to Greece at a 25% discount (on original value) the ECB and taxpayers would lose €1.8 billion. At a 35% discount the loss could be as high as €7.8 billion. This approach increases moral hazard since the burden is relatively higher on the ECB and therefore the taxpayer, i.e. taxpayers take the hit, rather than investors. In a complete restructuring where all parties accept large write downs there would be indiscriminate losses based on value of bonds held. As such there would be

Cited in *Ekathimerini.com*, "A Brady type plan may be needed for manageable debt to be growth compatible", 30 Jan 2011:

http://www.ekathimerini.com/4dcgi/_w_articles_wsite2_25768_30/01/2011_375915

¹⁶ Greek Ministry of Finance

<http://www.pdma.gr/%28S%28x4nnee3dzj2g2iikem40fn2l%29%29/ODDHX/StaticPage1.aspx?pagenb=471>

¹⁷ Cited in *Handelsblatt*, "The Greeks negotiate a longer repayment term", 1 Feb 2011:

<http://www.wirtschaftspresse.biz/psepp/fn/pcc/sfn/showedetail/DocID/1141558/EditionID/4/SectionID/2/PagelD/1141550/pDay/01.02.2011%2000:00:00/showtyp/1/SH/471a03123a2890ffdfd00536202a2d/index.html>

relatively less moral hazard as it would not be a purely taxpayer backed restructuring – though taxpayers would no doubt still take a significant loss.

Crucially, the use of the ECB and European institutions in first buying Greek government bonds from private investors (which the ECB has done) and then using taxpayer-guaranteed money in order to allow Greece to buy back these bonds at a discounted rate, also mean that even more of the risk associated with Greek debt is transferred from private bondholders to taxpayers.

- **Will private bondholders agree to sell?** Private bondholders' acceptance of any voluntary buy-back or swap of Greek bonds is uncertain. According to some estimates, banks are holding 80% of their Greek bonds to maturity to avoid declaring short-term losses at a time when their businesses are still vulnerable. This leaves only 20% on their trading books, meaning that they are reluctant to sell at this point in time for fear of having to declare substantial losses (since they bought Greek bonds at a higher value than what they will be asked to sell them for).¹⁸ If private bondholders do accept voluntary write downs, of a similar magnitude to the ECB, it is likely that the debt to GDP ratio could be reduced substantially more than our estimate. However, the likelihood of this happening is still unclear.

There is also a risk that the sudden increase in demand for Greek bonds, as a result of Greece itself having a €50 billion pot of money with which to purchase its own bonds, could actually lead to an increase in prices. This is problematic since the entire plan is based on the assumption that Greece will be able to buy back its bonds at a lower price than it sold them for, therefore reducing the size of its overall debt. But if the bonds are bought back at around the same price as they were sold for, the plan has achieved nothing.

4) WHAT IS THE WAY FORWARD FOR GREECE?

It is clear that the plan currently proposed by EU leaders, as we note above, will not come close to addressing Greece's endemic economic problems. For the Greek economy to get out of its slump once and for all, two huge steps need to be taken, both throwing up a number of problems of their own: a proper restructuring and a radical reform agenda for competitiveness. If these cannot be achieved then the only alternative is for Greece to regain control of its monetary policy and currency.

- **A proper restructuring:** It is widely acknowledged that a sustainable Greek debt to GDP ratio is below 100% at the very least. We estimate that to get down to this level a write off around 37% on *all* Greek debt would be needed, equivalent to around €126 billion. In contrast, the plan considered by EU leaders would only cut overall debt by between 2.4% and 4.2% and reduce debt to GDP by a maximum of 6.2% (see table below)¹⁹.

¹⁸ Cited in *New York Times*, "Odds are against a Greek restructuring", 24 Jan 2011: <http://www.nytimes.com/2011/01/25/business/global/25iht-inside25.html?src=busln>

¹⁹ Under the current plan we have assumed that the ECB holds €60bn worth of bonds bought at a discount. Since data is not available it could be that the ECB spent €60bn on bonds, meaning they own up to €77bn of Greek debt given an average purchase rate of 78 cents on the euro. If this were the case then the current plan would write off of between €12.45bn - €20.15bn (after this year's funding gap is accounted for). This amounts to a 3.65% - 6% reduction in total debt, or a debt to GDP ratio of 142.8% - 146%. This still leaves Greece well short of where it needs to be.

	Debt to GDP ratio 2011 (% of GDP)
Status quo	152
Current Plan	145 - 147
25% write off for all Greek debt	116
37% write off for all Greek debt	98.5

An extensive restructuring risks spreading contagion throughout Europe, the outcome of which is unknown. However, with the significant level of refinancing needed by Greece over the next few years it is an issue which will need to be addressed. An option which has been forwarded by the likes of George Soros and William Buitter, is that the bailout fund be radically expanded and used to tackle any contagion by offering guarantees or liquidity to those institutions which may require it due to losses from a Greek restructuring.²⁰ This is politically a very tricky proposition as it essentially rests on German willingness to guarantee hundreds of billions in eurozone loans. This also raises the same moral hazard issues which we discussed earlier. Regardless the upcoming European bank stress tests are of vital importance on this issue. They provide an opportunity for the European Banking Authority to fully assess the costs of a restructuring within the eurozone on the banking sector across Europe.

- **But nothing is solved until competitiveness is addressed:** Ultimately, however, Greece's main problem is not one of liquidity, but one of solvency and competitiveness. Even if Greece were, magically, to reduce its debt to GDP ratio to below 100%, it would lack a sufficiently strong economic base to grow and compete within a monetary union.

The discrepancy between Greece and central eurozone countries, Germany in particular, have only been increasing in recent years and remains a key driver of the ongoing troubles in the eurozone (see table).

Economic Indicators	Greece	Germany
	2011	2011
GDP growth (%)	-4	2.6
Debt to GDP (% of GDP)	152	75
Deficit (% of GDP)	8	1.7
Exports growth (%)	0	8.5
Imports growth (%)	-9.3	8
Domestic Demand (%)	-6.3	2
10 yr bond interest rate (%)	11.51	3.17
Unemployment rate (%)	12	7.3

Source: EIU country reports; ECB statistics; FT market data; Bundesbank projections.²¹

Real effective exchange rates since the euro was adopted show that prices and wages have risen significantly faster in countries such as Greece compared to Germany, in turn impacting on competitiveness. Greece's cost competitiveness has decreased by 13.8% since 1999 while Germany's has increased by 18.7%, a difference of 32.2%.²²

²⁰ Citi Global Economics View: The Debt of Nations by Buitter et al.

²¹ All forecasts were current at the time of writing and are subject to revision by the ECB, national governments or markets. www.bundesbank.de/download/.../mba/2010/201012mba_en_outlook.pdf.

²² ECB statistics: http://www.ecb.int/stats/exchange/hci/html/hci_ulct_2010-07.en.html

In order for Greece to rebound, it simply has to find a way to radically boost its competitiveness. Reforms have to strike deep into the Greek economy and society, ranging from a complete overhaul of the labour market (cutting internal costs), to a new, rigorous tax and pension system to regulatory reform across the board. The austerity measures and reforms currently pursued by Greece, while helping, will not be nearly enough to inject the necessary dose of competitiveness required for it to compete inside the eurozone.

The problem is that Greece is stuck with an overvalued currency, suitable for stronger economies such as Germany, without the option of currency devaluation. Instead, all of the above reforms have to come through domestic measures alone, meaning that the Greek population must effectively be forced to accept radical changes to their very way of life, i.e. painful reforms in the short-term to enjoy benefits in what will be perceived as an uncertain future. It is far from clear that the Greek population, with its strong unions and deeply rooted social order, will accept such far-reaching changes. Germany, in particular, hopes that such reforms can take place on an ongoing basis under a new eurozone “pact of competitiveness”.

Failing such reforms, Greece is likely to have to rely on permanent subsidies in some form from the stronger eurozone economies to compensate for the huge divergences in economic strength. It is possible that a combination of such measures will see Greece enter a new boom, however, as long as eurozone monetary policy does not fit the needs of the Greek economy a boom and bust cycle will continue.

Alternatively, Greece could seek to regain control of monetary policy by detaching itself from the eurozone. This would allow for currency devaluation, but will come with a range of other costs. The country is unlikely to go for this option unless pushed out or the economy deteriorates a lot more.

Ultimately, until the inconsistencies within the eurozone are recognised and addressed the long term future for Greece will be uncertain, even with a restructuring of debt. Restructuring on a larger scale could be a step in the right direction. However, in itself it will be woefully inadequate.