

Debt reduction without (a messy) default

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The government of Greece has apparently not been able to convince its own population that 'there is no alternative' to the second round of tough cuts and reforms required by its European partners, the ECB and the IMF. Moreover, investors are now convinced that the country will not be able to grow out of its public debt, which is now on course to top 160% of a shrinking GDP.

We would propose to take advantage of present low prices of Greek debt to implement a market-based approach to debt reduction:

The European Financial Stability Facility (EFSF) should offer holders of Greek debt an exchange into EFSF paper at the current market price. The offer would be valid for a limited time. Banks would be forced in the context of the ongoing stress tests to write down holdings also in their banking book and thus have an incentive to accept the offer. Moreover, the old bonds would be de-listed and no longer be accepted as collateral by the European Central Bank. This would ensure close to full participation in the exchange.

The result of this operation would be that the EFSF would hold almost all claims on the Greek government. The EFSF would then make an offer to Greece to write down at some point in the future the nominal value of its claims to the amount paid in the debt exchange; but only provided that the country really does implement the additional adjustment efforts being promised now. This would provide an important positive incentive to continue with reforms as the population would then know that the pay-off from the hardship would be a substantially reduced debt burden, with most of the losses borne by foreign investors.

While the EFSF finances the exchange of the stock of bonds, the IMF would fund any remaining fiscal deficits during the adjustment period under its normal conditions.

There are two key conditions for this approach to restore Greece's access to private capital markets in the longer-run: i) the remaining debt level must be sustainable at interest rates that incorporate a moderate risk premium, and ii) the EFSF claims must not be senior to those of private bondholders who might consider buying Greek bonds again several years down the road. EFSF support must be akin to an injection of equity into the country. This is the case for the existing loans under the Greek programme (and EFSF lending in general)

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and has now also been accepted for the permanent new European Stability Mechanism, due to start in 2013-14.

With even shorter-term Greek debt now trading at close to 50-60% of its face value, our approach would lead to a sufficiently large reduction of debt at a reasonable cost for the private bond holders. An average discount of 40-45% in the bond exchange would push the debt ratio below 100% of GDP and require bond holders to write off some €140 billion. Full participation could be ensured if Greece passes a 'mopping-up' law, as proposed by Lee Bucheit and G. Mitu Gulati last year.¹ Such a law would in effect create a 'statutory' collective action clause valid for the entire existing debt stock.

The ECB would need to participate in the exchange given that it holds about one-fifth of the stock of Greek debt. In order to save face and keep up appearances, the ECB would be offered a special bond with a very long maturity (say, 15-20 years) and a low interest rate. This bond could have the same present value as the market price paid under the Securities Markets Programme (SMP) by the ECB, and would avoid the realisation of losses and thus the need for a recapitalisation of the ECB.

Greek banks hold large amounts of government bonds on which they would make large losses. They would have to be nationalised and recapitalised, which will somewhat reduce the net fiscal benefit of the operation, but the cost should be bearable given the large foreign assets of these banks whose value should be approximately equivalent to the accounting losses Greek banks would realise in the exchange.

Compared to the mere token private sector involvement discussed now, or a rescheduling, our approach would have the advantage of offering a much higher chance to put an end to the debt crisis. It would probably be regarded by ratings agencies formally as a default, but since it would end the uncertainty about Greek debt this should be a manageable problem. Contagion to Ireland and Portugal should not be an issue because these countries are already under the EFSF umbrella and thus do not need to refinance themselves. Some contagion to Italy and Spain would probably result in the short run, but contagion has already happened and it might actually be reduced by a relatively 'investor-friendly' end to the uncertainty. The continuing political uncertainty in Greece means that without such a reduction in debt, the spectre of a really messy default will continue to weigh on markets.

¹ Lee C. Buchheit and G. Mitu Gulati, "How to Restructure Greek Debt", 7 May 2010 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304).