

Debt Reduction without Default

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The government of Greece continues to have difficulties implementing the promises it gave to its creditors and convincing its own population that ‘there is no alternative’ to further rounds of tough cuts and reforms. 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. Bond prices have fallen to between 35-45% of their face value.

We reiterate our proposal to take advantage of 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.

Compared to the approach currently pursued to obtain some ‘private sector involvement’ (PSI), this approach has the advantage that it provides meaningful debt relief – over 50% as opposed to close to nothing under the PSI proposal of July 21st, agreed with the Institute of International Finance (IIF), an association of international financial institutions. Moreover, it would not necessarily lead to a rating of ‘(selective) default’ since a transaction between two private sector participants does not indicate a reduced willingness to pay. (The ratings agencies consider a buyback by the debtor as selective default.) By contrast, the PSI proposal, as currently planned, would certainly lead to a rating of selective default (at least for some time). Moreover, our debt buyback proposal would not trigger CDS contracts.

Moreover, the liquidity of Greek banks would actually be improved since they can now use Greek government bonds as collateral for ECB financing only at the market price (35-45%) and must accept a substantial haircut on top of this. After the exchange, they could use Greek government bonds in repo operations close to the full face value of the new nominal value of the EFSF bonds they have thus acquired. For regulatory purposes, the Greek banks would of course need to be recapitalised (since their present holdings are still booked at 100%), but this could be done by giving them new Greek government bonds, which should be valuable since they would be issued after the debt stock has effectively been cut in less than half.

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The European Central Bank 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. The ECB could book the new bonds at par and would thus make a small accounting profit under its 'hold to maturity' accounting system.

For the EFSF, this approach would have the advantage that it would not have to engage in any new bond offering. The overall cost of the buyback, assuming a 90% participation rate would be around €125 billion, very close to the €109 billion foreseen in the second Greek package.

This approach would at least hold out the prospect of providing finality for investors, which in turn is the precondition for reopening capital markets for the Greek private sector. Strengthening confidence in and opening up refinancing channels for the Greek banking system are key conditions for stopping the continuous deposit flight which is taking place right now and which threatens to derail the current programme.

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 first to forgo some interest and then 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 payoff from the hardship would be a substantially reduced debt burden, with most of the losses borne by foreign investors.

Even the hold-outs would have to participate in the debt forgiveness of the EFSF 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.

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 condition 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.

The continuing political uncertainty in Greece means that without such a reduction in debt, the spectre of a really messy default and the associated contagion 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).