

## Greece must meet its restructuring fate

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It has been almost a year since the **€50bn European Financial Stability Fund** was created to bail out **over-borrowed Eurozone states**, of which Greece was the first to falter.

Despite a €110bn loan from its neighbours, substantial budget tightening and reforms, and a change of government, Greece looks today even further away from a return to the markets than it was before the crisis. Whatever it is that the EFSF's loan and the European Central Bank's market purchases of **Greek debt** were supposed to do, the market hasn't bought it. It clearly is expecting restructuring.

Recently *Der Spiegel* reported that several Eurozone finance ministers told ECB President Jean-Claude Trichet that the Greek stabilisation plans were behind schedule and the **debt ought to be restructured**. Mr Trichet reportedly blocked the idea and refused to discuss it, and the EU's Economic and Monetary Affairs Commissioner Olli Rehn agreed, saying that restructuring was out of the question. The main reason for their reluctance is the fear that any restructuring would have severe consequences on European banks, especially those from France, Germany and Switzerland.

This fear is well-placed because these banks have not accounted for their Greek or other sovereign holdings at market value, and accordingly, would have to incur substantial writedowns if a restructuring occurred.

Outstanding bank debt of all the peripheral countries held by banks now totals about \$600bn. Market prices of this debt range from about 60 per cent of par value to about 85 per cent, so perhaps 30 per cent, or \$180 billion, might represent unrealised losses – a manageable amount spread over several countries and numerous banks. The market is well aware of this, of course, and has already repriced the shares of the most exposed banks to reflect a fair market estimate of the current value of their sovereign debt holdings.

Facing the problems of bank losses is an integral part of addressing the sovereign debt issue. Neither the banks nor the distressed sovereign borrowers benefit from continued denial of the problem.

**European banks** are known to be undercapitalised, relative to their US counterparts, and are expected to have to raise additional capital over the next few years in any event. Refusing to acknowledge their Greek losses does nothing for the banks; the sooner their balance sheets recognise the reality of their holdings the better for them.

Greece, however, plainly needs restructuring to enable it to turn its economy around. It needs to reduce the total amount of its debt that is outstanding, reduce the interest rate it would pay for refinancing and lengthen the maturities of the debt so as to be able to repay it after its considerable belt tightening and reform efforts have had some effect.

Now that the European Structural Mechanism has been declared the permanent replacement of the EFSF, it ought to be possible to use an ESM guarantee to provide sufficient credit enhancement or collateral to allow a new series of Greek bonds to be exchanged for the old ones at their discounted market value, meaning that total debt would be reduced by around 30 per cent.

In the 1990s, after a few years of delay and denial – and fears of imposing unhealthy losses on the struggling banks that held the debt – 18 heavily indebted, distressed Latin American and other countries engaged in similar exchange. They offered old bank debt for new "Brady bonds", that were collateralised by a 30-year zero-coupon US Treasury bond. The programme was designed and orchestrated by the US, in order to clear up a huge problem of defaulted or underperforming sovereign debt.

The exchanges were well received, the governments were able to put meaningful recovery plans into effect, and banks stock prices began to rise. It was a market solution whose time had come. It is time now to do the same for Greece.

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