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How Should a Greek Debt Restructuring Be Done and What Are Its Consequences

By Nicholas Economides and Roy Smith
Stern School of Business, New York University

The future of Greece for the next decade and further depends crucially on how it will restructure its debt. However, the Greek public has very limited knowledge of what restructuring means and what will be its consequences. Additionally, the continuous denials do not allow for a healthy discussion of the issue of restructuring. The impression has been created that restructuring and bankruptcy are the same thing – a terrible disaster that has to be avoided at all cost. On the contrary, the truth is that there are many types and ways of restructuring, and some are much more beneficial to Greece than others. In this article, we answer some of the fundamental questions on the issue of the restructuring of Greek debt.

1. How big is the Greek sovereign debt?

The Greek sovereign debt was €328 billion at the end of 2010. EU partners and the IMF have promised Greece a €110 billion loan, so the remaining/uncovered Greek sovereign debt is about €218 billion. Since Greek GNP was €230 billion in 2010, Greek sovereign debt was 143% of GNP at the end of 2010.

2. Why is the Greek debt growing now?

For two reasons: first, the Greek government, despite cuts in public sector expenses, had a budget deficit of 10% in 2010, and that increased the debt. Second, the severe recession in Greece reduces the GNP and therefore increases Greek sovereign debt as a percentage of GNP.

3. Can Greece pay the full amount of its debt?

No. Even if Greece succeeds fully in cutting its public sector deficit and instead starts having public sector surpluses, debt reaching 150% of GNP cannot be fully financed from the surplus, even at a relatively low interest rate of 5%. This implies that the yearly interest will not be fully paid from the surplus and will result in increases of the accumulated debt. This is unsustainable.

At present, the interest rate of 2-year Greek debt is 25%. While Greek debt is unsustainable at a 5% interest rate, it is a death sentence for Greece at 25% interest rate. The solution is for Greece to restructure its debt, preferably through a voluntary exchange of old debt with new.

4. Are there other reasons that make Greek debt restructuring desirable?

Yes. Since May 2010, the Greek debt crisis has not allowed Greece, Greek banks and other Greek companies to utilize world capital markets. Greece and Greek companies need access to capital markets to help them grow. Restructuring will allow Greece and Greek companies to restore their access to international capital markets. Additionally, restructuring should be accompanied with a reduction of the debt, which we will analyze below. The reduction of debt reduces the interest that Greece pays.

5. What is a voluntary restructuring of Greek debt?

A voluntary restructuring means that Greece asks private creditors (excluding the institutions of the EU and the IMF) to voluntarily exchange their present Greek bonds with new bonds to be issued by Greece.

6. What is the best way to do a voluntary restructuring of Greek debt?

The best restructuring requires these four elements:

(a) To get interest rates of 5% or less, *Greece needs a guarantee from the ESM of the principal of its new bonds*. This will be similar to the "Brady bonds," issued by many Latin American countries (and others) that used as US Treasury bonds as collateral (and were named after US Treasury Secretary, Nicholas Brady).

(b) Greek debt comes due in a large part very quickly: €19 billion in the second part of 2011, €33.5 billion in 2012, €29 billion in 2013, and €32 billion in 2014, that is, €114 billion (more than a third of the total debt) in two and a half years. *The new debt issues will have longer maturities to make it more manageable.*

(c) Greek bonds presently trade at 30-36% *below* their par value. For example, Greek government bonds of different durations, were traded on May 3, 2011 at about 70% of their par value. When the new bonds are exchanged for old bonds, the exchange should happen at market prices. This means that the old debt should be exchanged at prices approximately 70% of face value, that is, with a "haircut" (loss to the holders of the old debt) of 30%.

    Therefore, *in exchanging its debt, Greece will be able to reduce it by 30% or more.*

(d) Restructuring should happen while Greece still has coverage of its loan obligations from the €110 billion EU and IMF loan. This means it should be done during the next eight to ten months.

7. Will bondholders accept the voluntary exchange?

Yes. Bondholders will do so to avoid further loss of value. The reduction of the total Greek debt and elongation of its maturity increases the probability that in the future there will be no further haircuts. For the incentives of the current owners of Greek sovereign debt to participate in the exchange is that the new bonds will have the guarantee (at least for their face value) of the ESM. The Brady method (here adapted to the ESM guarantee) used in 18 countries, was very well-received, and the new bonds issued appreciated over time.

8. Why does restructuring reduce Greek debt?

Greek sovereign debt is reduced because the old bonds are bought back at a haircut of 30 (or more) below their face value.

9. Does a voluntary restructuring mean bankruptcy?

No, it does not mean bankruptcy of Greece.

10. Will Greece continue to pay civil servants after a restructuring?

Yes, as long as the restructuring is done during the period when loans are covered by the EU and IMF loan, that is, during the next 8-10 months. Once the new bonds are issued, in determining the total amount to be offered, there should be an allowance for any continuing deficit of the public sector for at least 2-3 years, and the total new debt should cover these deficits. After that period, the public sector should be operating at a surplus.

11. Will Greek banks have problems after a restructuring?

Greek banks have about €40 billion exposure to Greek bonds. Most of the Greek bonds are held by banks in their "capital account" at face value, not at the present market value that reflects the haircuts. At restructuring, Greek banks will have to write down Greek bonds to market value (at which Greece will buy them to be exchanged). This can imply realizing a loss of about €12 billion to Greek banks id the haircut is 30%. This loss has already occurred, but its accounting realization will happen at the restructuring. Greek banks have a present capitalization of about €15 billion in total. They need to recapitalize or get a significant injection of convertible bonds from the Greek government like Citibank received from the US government in 2009.

12. Some advocate to avoid writing down the banks' capital after a restructuring.

We disagree. Balance sheets of banks should accurately reflect the market value of their assets. The Bank of Greece and the ECB should not allow banks to use gimmicks to give the impression that banks' assets are higher than they really are. Looking forward to the day after restructuring, the Greek banks should make it their first priority to recapitalize.

13. Will other European banks have problems after a restructuring?

Probably not. Most banks have relatively small exposure to Greek debt. Some banks with large exposure to Greek debt may need recapitalization.

14. Will Greek pension funds have problems after a restructuring?

Not any different than their present problems. Some say that Greek pension funds will not be able to pay pensions because they hold Greek bonds. Greek pension funds have about €40 billion in Greek bonds, and most of them are written in their books at full value, although they are presently trading at 30%-35% below par. The fact that the real value of the bonds is much smaller than in their books has not stopped pension funds paying pensions. Writing the correct value of Greek bonds in their books at a restructuring will not affect their ability to pay pensions. The loss has already occurred, and a restructuring does not create a new loss.

15. Does restructuring mean that no more sacrifices are needed?

Restructuring does not solve the problem of the Greek public sector deficit. *More sacrifices, including lowering expenses and increasing revenue will be needed for Greece to be able to create a public sector surplus*. However, restructuring lightens the debt load and the interest that Greece has to pay every year.

16. Does a voluntary restructuring mean that Greece will leave the Euro or the EU?

No. It is in the best interest of Greece and its EU partners for Greece to remain in the Euro and the EU.

17. Does voluntary restructuring require financial support from the EU?

No. It does not require further financial support from the EU. This is in contrast with many other proposals that require significant additional EU support.

18. Some claim that a restructuring will be catastrophic. Why?

Usually this point of view is based on the idea that, if a restructuring occurs, there will be much more resistance to structural reforms, budget cuts, and reduction of tax evasion. The proponents of this point of view state that it is better to postpone the restructuring as much as possible to give a chance to the reforms to be implemented and work.

This point of view is incorrect. First of all, restructuring is not a panacea. It will not solve the problem of the public sector deficit where expenses are much larger than revenue. Therefore, even after the restructuring it will be necessary to continue structural changes, reduction of public spending, and efforts to reduce tax evasion. The fact that many Greeks think that all these will not be necessary after restructuring is a huge failure of the Greek political parties and the Greek media in educating the Greek public on what a restructuring means and its implications.

Not only is not restructuring against the changes, but also, restructuring helps these changes by reducing interest that Greece pays on debt and allows Greek companies to access financial markets once more. We discuss below why the postponement of restructuring can be catastrophic.

19. What are the consequences of a postponement of the restructuring?

Postponement is extremely dangerous. Greece has an 8-10 months "window" during which it is covered by the loan of the EU and the IMF and it can roll over its debt using money from this loan. When this window closes in the middle of 2012, Greece will need to finance the rollover of its loans from international markets. Interest rates in these markets for Greek debt are 15-25%, far exceeding what Greece can pay. When it finds itself in this position in the middle of 2012, Greece will not be able to do a voluntary restructuring. It will be forced to declare bankruptcy. In contrast with voluntary restructuring, this bankruptcy will be catastrophic, will exclude Greece from capital markets for years, Greece may be unable to pay salaries and pensions to civil servants, and could lead Greece out of the Euro. *Bankruptcy and its catastrophic consequences will be the result of the delay of restructuring. Greece needs restructuring in 2011.*

20. What do you think of the point of view that there is no need for debt restructuring, but only an elongation and better terms for the loan from the EU and the IMF?

Better terms (such as lower interest rate and elongation of maturities) are definitely useful for Greece. But they do not solve the problem that is solved by the restructuring. In mid-2012, having spent the entire loan from the EU and the IMF, Greece will need to roll over its debts coming due then by financing from international capital markets. Greece cannot do that at the present huge interest rates. If Greece does not do a voluntary restructuring before the first quarter of 2012, it will have to declare bankruptcy in mid-2012 with catastrophic consequences.

21. Greece found itself at the edge of the cliff in May 2010 but was "rescued." Could that not happen again in 2012.

The chances that Greece will get an additional loan from the EU and the IMF in 2012 are small. After Greece, Ireland and Portugal received similar loans. In various EU countries there are significant political reactions opposing these programs. Instead of being at the mercy of political developments in a number of countries waiting the salvation of a new loan from deus ex machina, Greece should implement now the voluntary restructuring solution. Greece should not wait until it is (again) at the edge of the cliff without any negotiating power.