

## A National Strategy for the Greek Sovereign Debt\*

By Nicholas Economides\*\*

Greece needs to create and implement a national strategy on managing its sovereign debt. Even though this task is of paramount importance and Greece teeters on the verge of bankruptcy, Greece lacks a national strategy on the debt issue. All “solutions” come from Berlin, Frankfurt, Paris and Brussels – none originates in Athens. And these solutions put first the interests of the EU banks and financially powerful EU states rather than the Greek national interest. Greece needs to formulate and put forward its own proposal and negotiate with the creditors on its debt. Instead of renegotiating the aid package, Greece should focus on negotiating a solution to its debt problem. The features of the solution of this issue will define the Greek economy for decades. The lack of a common position of the ECB and financially powerful EU states on the issue of Greek debt has provided Greece with a golden opportunity to propose its own solution, and this solution be accepted. Even in its difficult position, Greece has this possibility, and a significant probability of success.

A national strategy for Greek sovereign debt needs to achieve the following:

1. Convert present debt to long term debt to avoid a default in the next two years. No matter how successful the reforms are, Greece will default if it does not convert its short term debt to long term debt.
2. Reduce the size of the total Greek debt. To pay the total amount of debt, Greece needs very fast sustained growth year after year over a fifteen years – not impossible but very unlikely. Otherwise, Greece requires a significant reduction of the total debt burden and has to focus on the way that this can be done best in the national interest.
3. Keep Greek banks afloat, liquid, and with sufficient trust to them. Greek banks have been subject to a prolonged bank run for over a year, as depositors have withdrawn large amounts. Every day that the debt problem is not solved, there is a chance that the bank run will become acute with truly disastrous consequences for the banks and the Greek economy. Such events may be triggered by the idiotic remarks of prominent Greek politicians that Greece is leaving the Euro, a Spiegel story, or practically any rumor in the Greek or foreign media or the Internet. The danger to Greek banks alone is sufficient to require the immediate solution of the Greek debt problem.
4. Improve the quality of Greek debt to be able to achieve lower interest rates. The present market rates for Greek sovereign debt, from 11% to 26%, are prohibitive for Greece. Greece cannot afford to borrow at interest rates above 4-5%. It will achieve these interest rates only if it increases the quality of the bonds. That can be done by either by buying high quality liquid collateral such as Eurobonds or by a guarantee from the European Stability Mechanism (ESM).
5. Be based on the true reality of the situation and should not expect Greece or its partners to do the impossible. In their attempt to please voters, politicians in Greece and the EU with very

short horizons have often agreed on terms that are unfeasible. For example, the first aid agreement said that Greece would come back to the financial markets in 2012, even though no one believed this to be feasible.

6. Should be a comprehensive solution and not an attempt to kick the can further down the road.
7. It would be useful but not absolutely necessary for any refinancing not to create a “credit event” that would lead the rating agencies to declare Greece in default.

The possibilities for Greece are limited, but there is a very good option. My proposal is as follows:

Greece offers new high quality long term bonds in exchange for its existing bonds. The new bonds have guarantees on their principal based on high quality liquid assets such as Eurobonds, not on real estate or stocks. This is essentially an adaption to the current European conditions of the Brady Bonds plan that has been used very successfully in 17 countries. Instead of buying the high quality liquid asset as in the original Brady plan, Greece can use instead a guarantee of the principal of its new bonds by the ESM. This will be less expensive and equally effective.

Greece should take advantage of the fact that its bonds are trading significantly below their face value. Since its bonds are trading at a 30% or higher discount, it is irrational for Greece to pay full value for them. If Greece pays for them at their maturity 30% below their face value (30% haircut), it will be considered a “credit event” and Greece will be declared in default. However, Greece can buy the large majority of its existing bonds in the open market before their expiration at a 30% discount from face value (30% haircut) without triggering a credit event. Instead of using the money provided by the EU and the IMF to pay for its bonds at maturity at face value, Greece can buy them earlier in the open market at 30% discount. If the EU and the IMF do not trust Greece to buy its bonds in the open market, this task can be given to the ESM. Then the ESM would sell the bonds to Greece before their expiration, at the price the ESM paid for them. Greece will then use the money from the EU and IMF loan to pay the ESM for these bonds. This procedure, based on market transactions (which are truly voluntary) cannot be considered a “credit event.” Using this procedure, Greece reduces its debt by 30% or more.

With the irresponsible permission of the ECB and the Bank of Greece, Greek and other EU banks have written the vast majority of Greek bonds in their books at face value even though they are exchanged every day in a market with a 30% or more haircut. Greek banks and some EU banks will have liquidity problems if they have to write down Greek debt to its true value all at once. However, with the buy-back procedure that I propose, banks will realize their losses over time as they sell their bond holdings, which can give them time to increase their capital and to be able to absorb the full loss. As a last resort, the Greek government could support the Greek banks directly, as the US did for Citibank in 2008. Direct and transparent support is preferable to the current complex and opaque situation.

Other proposed solutions have significant problems. The solution of the French banks exchanging present bonds with 30-year new ones has a very high interest rate (higher than the market interest rate!) that Greece cannot pay. The rollover is only 50% of the bonds at French banks, and it can create a “credit event” according to the rating agencies. The French solution has the advantage that it puts money aside as a guarantee. But the loan terms would be much more beneficial to Greece if she herself would do that, rather than the French banks. The German solution exchanging current bonds with 5- or 7-year ones does not give enough time to the Greek economy. Additionally, a large percentage of the Greek debt is no longer in the hands of banks, since they have sold it to private investors and hedge funds. A solution has to cover almost all the creditors, not just the banks.

In conclusion, Greece needs a national strategy for its debt. Even though the possibilities are limited, the adaption to the current conditions of a Brady Bonds solution, with the specific elements discussed above, is much better for the Greek national interest than all other proposals. It is imperative for the long-run Greek national interest, and for the survival of the Greek banks, that Greece takes the initiative on the issue of its debt.

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\*\* Stern School of Business, New York University, New York