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# Forcing Greek restructuring is not the answer

By Lucas Papademos

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As the Greek debt crisis has escalated, so have calls to restructure the country's public debt, in order to support debt sustainability, improve long-term growth and reduce moral hazard. In fact, though, the likely financial benefits of debt restructuring would be much smaller than is often envisaged, the process entails significant risks for Greece and the euro area.

The benefits of a sovereign debt restructuring by a eurozone country depend on the distribution of debt across creditors and their capacity to absorb such losses without government support. However, there are also funding constraints and financial interlinkages, stemming from the functioning of the European monetary union and the integration of financial markets, that can erode benefits and generate systemic risks.

In the case of Greece, the nominal value of outstanding central government debt was €366bn at the end of July 2011. Almost 30 per cent was held by Greek residents, mostly banks, pension funds and insurance companies. A substantial reduction in the nominal value of Greek debt held by these institutions would have to be largely offset by government financial support. Losses sustained by Greek households and non-financials holding public debt would hit economic activity and tax revenues.

Another large share of outstanding Greek government debt is held by official institutions. At the end of July 2011, eurozone governments, the International Monetary Fund, the European Central Bank and other official institutions held almost a third of Greek government debt. For institutional, political and legal reasons, there can be no debt restructuring resulting in losses that would burden these official debt holders.

Thus, only restructuring the debt held by foreign private investors – approximately 40 per cent of total Greek government debt – would bring net financial benefits. A 50 per cent haircut would reduce the total debt by about 20 per cent.

The adverse consequences for Greece of a “hard”, involuntary debt restructuring and a sovereign default are not limited to the costs of recapitalising domestic banks and supporting pension funds. The effects on confidence, the liquidity of the Greek banking system and the real economy are likely to be substantial, though difficult to predict and quantify. Such effects would also undermine the fiscal consolidation process, especially if

debt restructuring causes a credit crunch. The ECB would not accept as collateral securities downgraded to default status. It would thus be necessary to provide “credit enhancement” to improve the quality of this collateral at a cost that would ultimately be borne by the Greek government.

Furthermore, if there is an involuntary debt restructuring and sovereign default of a eurozone country, the risk of financial contagion and spillovers on banks is likely to be significant and far-reaching. The recent sharp increases in sovereign bond yields in the eurozone have been sending loud and clear warning signals in this respect.

At the moment, the most effective and prudent way ahead is to implement the agreement of the European leaders in July, appropriately reinforced. Europe’s banks would definitely need to be recapitalised. But it would also be essential to increase the financial resources of the European financial stability facility and enhance its flexibility.

The agreement reached concerning private sector involvement in financing Greek debt should be essentially preserved. Possible modifications to improve debt sustainability by encouraging a larger haircut in the envisaged bond exchange are likely to imply a modest debt relief. Any changes in the PSI should not jeopardise its voluntary nature and should not lead to a credit event. In the case of sovereign default, the strengthening of the banks’ firewalls and the EFSF’s firepower would have to be substantially greater to protect financial stability.

There are no free lunches for debtors and no easy solutions for creditors. An involuntary restructuring of Greek sovereign debt is likely to result in modest net financial benefits and pose substantial risks that would seriously threaten the financial stability and economic performance of the eurozone as a whole. The realisation of these risks would ultimately impose a heavier burden on European taxpayers, have undesirable consequences for the stability and cohesion of the eurozone and undermine the credibility of the euro. For all these reasons, a comprehensive and convincing policy package that can help restore market and public confidence is urgently needed for the resolution of the European debt crisis.

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