Guest Editorial

The Greek Tragedy

Journal of Banking Regulation (2010) **11,** 257–259. doi:10.1057/jbr.2010.19

- Greece is in a debt trap, it is borrowing money to be able to repay outstanding debts.
- Austerity and extreme measures are the only options for Greece.
- As soon as markets calm down, Greece should re-profile its debt (as an EMU member default is not a political option).

ACT I – THE CURRENT SITUATION

The global financial crisis of 2007 has resulted in an overall increase in sovereign debt levels. Fiscal balances (as a ratio of GDP) have deteriorated. This deterioration is mainly because of falling revenues resulting from decreased real and financial activity. According to the IMF's data, in 2010 advanced countries will average a budget deficit of −8.3 per cent, whereas emerging economies will average one of −3.3 per cent. In advanced economies public debt to GDP ratio will reach the level of 97 per cent in 2010 (rising from below 75 per cent in 2006), whereas in emerging economies this will be 37 per cent (almost equal to 2006 level).

This increase in debt levels is the result of a shift in risk allocation, that is from the capital markets to the sovereign arena. In other words, the turmoil of the markets has been calmed down by pouring government financial aid, which, in turn, resulted in a considerable increase in the amount of sovereign debt. Although financial markets seem to be at ease, sovereign debt markets are very fragile at the moment.

Following the most recent restatement of Greek data by Eurostat, Greece reached a budget deficit of −13.6 per cent and a Debt/GDP ratio of 115 per cent in 2009. The profile of deficit reduction is more modest in the revised Stability and Growth Program (SGP) than it was in SGP published in February, reflecting the upward revision of estimated deficit and the downward revision to the growth projections. In the revised SGP, the Greek government is aiming for a budget deficit of −4.9 per cent of GDP in 2013 with an outstanding debt/GDP ratio of 149 per cent. The restatement of the data together with the effect that the global financial crisis had on the economy led the rating agencies to downgrade Greece to Ba1 (Moody's) with stable watch, BB+ (S&P) and BBB− (Fitch) with negative watch.

With a total nominal debt outstanding at €298.5 billion (as of December 2009), that is debt/GDP ratio at 115 per cent and above (way over the prudent 60 per cent to 90 per cent threshold), Greece is obliged to pay high interest rates compared to other countries.

On 2 May 2010, Greece officially received the support of the EMU and the IMF by means of a credit line of almost €110 billion that will be available for the next 3 years (€80 billion provided by the EMU and €30 billion from the IMF). This eases the current liquidity concerns (as refinancing of short-end debt will be achieved without accessing the markets). However, further austerity measures of €30 billion

(that is, almost 13 per cent of Greek GDP) have to be implemented.

ACT II – THE NEED TO RESTRUCTURE: MECHANISMS OF SOVEREIGN DEBT RESTRUCTURING

Broadly speaking, sovereign debt restructuring can be understood as the mechanism used by a sovereign state to prevent or resolve debt issues and to achieve debt sustainability levels. It has two aspects: procedural and substantial. While the procedural aspect focuses on the manner in which the restructuring should be performed (that is, its architecture), the substantial aspect is the actual restructuring of debt, which is normally characterized by rescheduling amortization schedules as well as writing off the debt principal. It is worthy of note that as sovereigns cannot go bankrupt, the only available mechanism is an exchange offer that can be enhanced by different techniques.

Recent restructurings by Belize, Grenada and the Seychelles clearly establish that restructuring is possible within the given parameters and limitations by the tactical and often complementary use of collective decision-making provisions and exchange offers. Collective decision-making provisions are contractual terms that allow the bond to be restructured with the favourable vote of the majority of the bondholders. Exchange offers are voluntary processes where holders of an outstanding bond are offered to exchange their bonds for newly issued bonds, usually with worse financial terms. The terms of the bonds in each of these cases had determined the restructuring technique that was to be adopted, that is exchange offers and amendments either to New York State law or English law.

Greece is currently borrowing at very high interest rates and short maturity periods. Therefore, there is only one available option: an exchange offer to extend maturity and reduce interest rates. This exchange offer will be called restructuring (if it is performed after default (and would probably include a face value reduction) or debt re-profiling if performed before default). Greece, as an EMU member, will not be allowed to default owing to political reasons.

Note that in 2001 Argentina defaulted on US$81.8 billion of sovereign debt after months of turmoil in the country's banking system. The end result was that Argentina abandoned its exchange rate regime and GDP fell by 10.9 per cent that year. In addition, Argentina has been locked out from international capital markets ever since (currently after almost 10 years it tries to resolve a discussion with residual holders of almost $20 billion of bonds). In a similar scenario, in 2003 Uruguay managed to re-profile its external debt, and was able to re-access the capital markets in just a month of receiving very positive credit ratings.

In Ancient history, the Greek tragedies were performed in early April at an annual state religious festival in honour of Dionysus. Hopefully, a debt re-profiling can be achieved and a default averted. Therefore, Greek tragedies will continue to be a circumscribed to play writers and actors in theatres, rather than something installed in the streets of Greece affecting its citizens and international investors as well as others in the Euro-zone.

ACT III: TO BE IN THE EMU OR NOT TO BE IN THE EMU, THAT IS THE QUESTION

As an EMU member, there are two main constraints that the member countries are facing. First, loss of monetary independence (ability to print money). Second, no control of setting a benchmark interest rate that drives the cost of money on the domestic economy. These two issues are interlinked monetary policies, both of which have been delegated to the European Central Bank.

The combination of higher interest rates and austerity measures to reduce budget deficits, and thus control sovereign debt, can be a 'toxic'

one that raises many questions. Given that Greece does not have control over its currency in order to buy its way out (by means of printing money, devaluating the currency and external inflation), and given that interest rates may soon increase, internal devaluation (adjustment of internal salaries and prices) is the only viable solution. In this sense, Latvia is an interesting case study because although it has its own currency, it has a pegged exchange rate with the euro, having several similarities with Greece, who effectively does by being a member of EMU. In the last 2 years, Latvia has seen a historical drop in GDP of more than 25 per cent. This makes Latvia's loss greater than that of the United States during the Great Depression downturn of 1929–1933. By implementing an internal devaluation, all the adjustment is made through pushing down prices and wages. With Latvia's unemployment rate reaching 22 per cent, this adjustment has been painful.

As previously mentioned, Argentina suffered a deep recession from 1999 to 2001 (above 20 per cent reduction in GDP) as it tried unsuccessfully to adjust its economy under a fixed exchange rate regime where its currency was pegged to the US dollar. With rising interest rates to finance budgetary deficits – which implied a rising public debt burden – this proved impossible, and on December 2001 the country defaulted on its external obligations, leading also to abandonment of the peg.

The biggest challenge that Greece is facing ahead is how to effectively implement the tough measures required. People can argue about the right manner to implement the measures, but not whether they should be implemented. The 'Dionysian' days of joy and excess where Greeks were still able to obtain what is commonly referred to in banking and financial circles as 'a free lunch' are over. Now politicians have to deal with angry voters feeling the pinch in their pockets while trying to get Greece out of this delicate situation. Experience in other countries has shown that it is not easy. For example, in one country there have been more than five presidents over a month and an imaginable number of demonstrations and riots with severe political and social consequences, including deaths.

A debt re-profiling can help ease some of the pressure of the internal devaluation by reducing the debt-servicing burden. Jamaica is an excellent example, where interest costs and principal repayments exceeded the country's revenues. Through a voluntarily domestic debt exchange offer earlier in 2010, Jamaica released some of its servicing debt burden. Therefore, following this example, Greece should take advantage of the liquidity that has been provided by the EMU and IMF to carry out an orderly debt re-profiling (voluntarily exchange offer) that will not trigger the CDSs linked to the Greek bonds.

Austerity and extreme measures are the only options for Greece. Unfortunately, it seems that Dionysius will not be around the Greek tables for a while.

The opinions expressed herein are personal and do not necessarily reflect those of the institutions that they represent.

Ioannis Kokkoris
University of Reading, Reading, UK

Rodrigo Olivares-Caminal
UNCTAD, University of Warwick

Kiriakos Papadakis
Canea and Associates SA