

# Lessons For U.S. Bondholders In The Greek Debt Spiral

Jun. 7 2011 - 2:04 pm | 4 views | 0 recommendations | 0 [comments](#)  
 Posted by [Sherli Looi](#)

The European Union and the IMF just approved their fifth installment of the original 2010 bailout to Greece. The next 12 billion euros will be paid in July, on the condition that Greece increases its austerity programs and asset sales to 78 billion euros by 2015.

This is a recipe for disaster. An insolvent nation with no surplus prospects cannot buy time. The economic deficits, debt servicing burden and debt of the nation will accelerate, fueling social unrest until a sovereign default or a debt restructuring occurs, as in the case of Argentina in 2001. Or until investors finally recognize that the risk premium ratio makes restructuring inevitable. This is easily illustrated by the table below which depicts the consequences of two hypothetical actions.

## Facts of the Case

As of June 3, 10-year Greek bonds yielded 16%, and 2-year notes traded at 25%. Moody's Investor Services had downgraded the bonds to junk, Caa1, and estimated the probability of default at 50%. Furthermore, 50% of Greece's debt matures in five years or less. The country's estimated 2011 GDP is 213 billion euros (based on a euro exchange rate of \$1.43), its debt is 327 billion euros and the unemployment rate is 14.6%. [Global Finance](#) reports that the Greek economy will be in recession for three years in a row: contracting 2% in 2009, 4% estimated for 2010 and 2.6% forecast for 2011

## Hypothetical Case 1: The Death Spiral

This alternative is to keep lending to Greece, with voluntary extensions of maturing debt and no restructuring. This is the current solution provided by the EU and IMF. Even though Greece is now effectively shut out of the capital markets, the calculations are based on assumptions which are far more benign than reality. It assumes that Greece has full access to the capital markets and all maturing debts will be renewed at 10% coupon.

Actions Taken in 2011	Effects of Actions, Billions Euros				
	5 years 2016	10 years 2020	15 years 2025	20 years 2030	
<u>The Death Spiral:</u>					
<i>No Haircut at all, assume debt can be</i>	Debt/GDP	209%	246%	342%	475%
	GDP	201	232	269	312
	Debt	419	572	921	1483
	Surplus	0	0	0	0

*renewed upon  
maturities*

*The Growth Spiral:*

<i>50% Haircut 2011</i>	Debt/GDP	82%	39%	0%	0%
<i>assume debt can be</i>	GDP	235	286	351	688
<i>renewed upon</i>	Debt	192	110	0	0
<i>maturities. 100%</i>	Surplus	0	0	38	306

*Surpluses applied to  
debt repayment*

The other assumptions include: no surpluses available to pay off debt; that the budget will be balanced from 2014 onwards and that GDP grows at 3% after 2015. The calculations are based on the start points of GDP at 213 billion Euros and debt of 327 billion Euros at the start of 2011.

Without debt restructuring, the Greek economy cannot generate surpluses to pay off debt and together with the weight of interest payments, its debt to GDP ratio will increase from the expected 150% in 2011 to 209% by 2016, and to 475% in 2030, about twenty years hence. Greece's debt would spiral from 327 billion euros now to *1.483 trillion euros* in 2030, a 4.5 times increase.

The historical economic crisis experienced by [Argentina](#) indicates that Greece will probably have to restructure sometime in the future, whether this event is prompted by similar chaotic fate or a planned transition. In the case of Argentina, after four years of recession and social unrest, its government collapsed and ceased all debt payments in December 2001.

Argentina's final offer in June 2004 was a 75% reduction in the net present value of its debt, then the largest proposed write down of sovereign restructurings. This offer was eventually modified but a debt restructuring did occur.

### **Hypothetical Case 2: A 50% Haircut in 2011**

Debt restructuring has severe consequences and cannot be taken lightly. Vast wealth is destroyed for the bond holders and the rippling effects of this wealth destruction would most likely spill into currency and equity global markets in various degrees in the short term. However, this bitter medicine is the only recourse left for Greece, given its dire economic situation and bleak prospects. A 50% haircut in 2011 will mean painful effects now, especially for the current debt investors, but it would allow Greece to grow out of its hole.

Assuming that monetary and fiscal disciplines are practiced throughout, the calculation shows that in 5 years, the debt to GDP ratio falls from the estimated 150% now, to 82% in five years, and then to *zero in 15 years*.

Its GDP will grow three fold, from 213 billion Euros forecasted for 2011 to 688 billion in 20 years time. Best of all, instead of a debt burden of 1.483 trillion Euros, Greece will have a *surplus of 306 billion Euros by 2030!* Greece has the potential to become a vibrant growing economy instead of remaining in its current quagmire.

The hypothetical examples point clearly to debt restructuring. Will the current stakeholders agree to this?

According to the [Bank of International Settlement](#)'s quarterly review ended December 30, 2010, Table 9B shows that European banks hold 81% of Greek debt. France is still the biggest holder at 29%, followed by Germany at 18%. The United Kingdom and the US holds 13% and 7% respectively.

The additional but significant consideration is that if Greece is allowed to restructure its debt, so should the other four similarly economically challenged and debt laden nations, namely, Ireland, Italy, Portugal and Spain.

To put things in perspective for the stakeholders, restructuring is an extremely costly exercise. The total debt burden of these five countries (GIIPS) is US\$ 3 trillion, of which 74% is held by European banks, led by France (19%) and Germany (16%). Fortunately the US holds only 5%. Yet, the globalization of finance means that no major country goes unscathed by a GIIPS restructuring.

So, even though the logic is clear, the decision process is difficult at best. This Greek debt drama has profound lessons for the U.S. whose debt to GDP ratio is expected to reach 90% by 2012 according to [Richard W. Rahn](#), a senior fellow at Cato Institute and Chairman of the institute for Global Economic Growth.