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Solving the Greek Crisis

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A solution to the Greek debt dilemma exists.

- The Economic Subcommittee (ESC) to Bank Advisory Committees during the Brady Debt restructuring era provides a blueprint for identifying common ground, deepening communication, and paving the way for the benefit of creditors and debtors alike.

- Greece must reverse an economic slide – already in its third year. Greece is now ripe for a "Brady" moment.

- A Vienna Initiative approach will likely prove woefully insufficient, as the relief falls short of providing what is needed and incentives differ between Greece's creditors and those participating in the Vienna Initiative.

- History shows how debt reduction coupled with significant reform can spark growth. Brady Plan recipients all demonstrated superior growth in the five years after plan implementation – with the exception of Ecuador.

- Preliminary calculations based on limited publicly available data suggest that Greece could achieve 2% to 3% growth on an annual basis with a 20% to 40% reduction of debt, principal payment re-profiling, and a meaningful reform effort. The European banking system would likely experience a manageable loss of EUR23.2 to EUR46.4 billion.

- Today, the Greek situation is vastly more complex. Yet, principles from the ESC provide a framework for an honest assessment of the present situation as well as a potential pathway for resolution to the Greek debt dilemma.

The Brady Plan and Economic Process

In the Less Developed Country (LDC) Debt Crisis, the analytic approach and communication established during the transition from the Baker Plan to the Brady Plan now provides a blueprint for a solution to the Greek debt dilemma.

The Brady Plan acknowledged that the debt burden in many LDC nations was unsustainable and needed to be reduced for the benefit of creditors and debtors alike. This represented a sharp contrast to the Baker Plan, where official institutions such as the IMF, friendly nations, and private creditors lent additional funds with the hope that credit quality would improve with growth. The Baker approach led to stagnating LDC economies and mounting debt burdens for eight years before the Brady Plan paved the way for the birth of the Emerging Markets asset class and a powerful long-term growth story.

The present official approach to Greece is strikingly similar to the late stages of the Baker Plan, where new lending or a Vienna Initiative approach fails to address the underlying problem.

A Brief on the Economic Subcommittee: Blueprint for Greece

The success of the ESC process was in identifying a reasonable common ground between creditors and debtors. The central purpose of the ESC was to formulate an empirically based solution to the debt overhang problem, where both debtors and creditors would benefit. The analytic process also forced direct communication among debtors and all major creditors.

The approach began with a growth rate objective for the debtor nation. The idea was that strong and viable growth was essential for enhancing the sustainability of any new programs, improving the quality of credits held, as well as putting a human face on debt restructuring.

A specific three pronged strategy helped connect the dots across issues and set the foundation for success. Areas included:

- ***Economics*** – A thorough assessment of economic prospects was necessary to support the targeted growth trajectory. For example, what are reasonable fiscal objectives? How would the trade balance or financial flows be impacted by debt reduction? How would contemplated reform measures impact the nation's capacity to consistently service its debt, while meeting growth objectives?

  Economic reform is requisite and must be owned by the country.

- ***Finance*** – Debt and liabilities need to be restructured. What is the range of haircuts on financial obligations that would lead to affordable principal and interest payments over time? What would the impact of such a reduction be on banks and other exposed financial institutions?

- ***Official Institutions and Bilateral Creditors*** – In the Brady Plan, official institutions and bilateral creditors played a pivotal role in facilitating the transition to more rational debt levels with a far more certain probability of payment. However, all was not easy. Resources – then as now – were scarce and needed to be adequately budgeted and used most effectively.

The ESC approach helped balance many competing interests during the challenging transition from the Baker to Brady Plan.

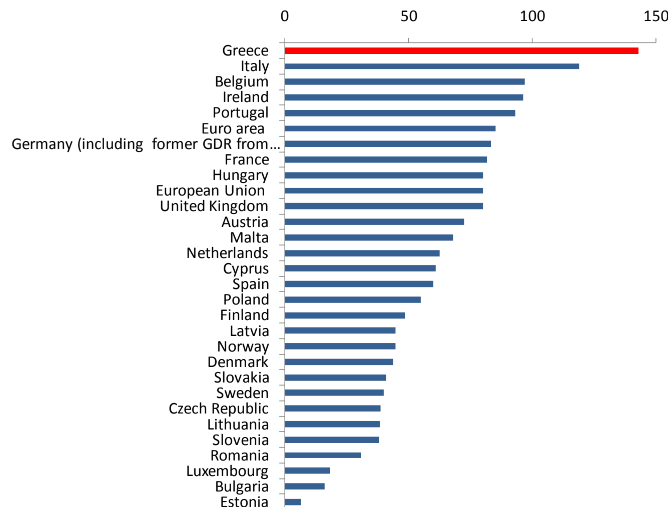
Next Steps and the Vienna Initiative

The first step toward a successful resolution to the Greek debt dilemma is the realization that substantial debt relief is requisite and this constitutes a default. Greece's general government debt exceeds a stunning 150% of GDP or more than double the Maastricht criteria for a benchmark of 60%.

At present, official institutions are now promoting a Vienna Initiative type arrangement as a solution to Greece's debt dilemma. Careful examination of the Vienna Initiative clearly indicates that the approach

will likely prove woefully insufficient. Market pressures combined with the strain of continuous payments falling due will likely lead to a swift collapse of any Vienna-type arrangement. The numbers fail to balance and the incentives of Greece's creditors are likely quite different than those in the case of the Vienna Initiative.

Figure 1. Greece Carries the Highest Debt Burden in Europe: General government gross debt, % of GDP



Source: European Commission - Eurostat (June 2011) and Center for Financial Stability Inc.

Although the Vienna Initiative is a creative approach designed by the European Bank for Reconstruction and Development (EBRD) to address the Emerging European banking crisis in 2009, the present dilemma in Greece warrants a different and more drastic solution. The Vienna Initiative simply coordinated a response to the threat of European Banks withdrawing lines of credit that had been extended to their subsidiaries in Emerging European nations.

The present situation of creditors to Greece is quite different from those of major European financial institutions with subsidiaries in Emerging Europe, for example:

- Creditors to the Emerging European nations had a long-term strategic interest in the region. In other words, many of the large European banks were readily persuaded to preserve exposure to their Emerging European subsidiaries. Expansion of those institutions represented a major part of their growth and business strategy in the past and into the future.

  In the case of Greece, many of the creditors are bondholders and unfortunately likely have less of a long-term strategic interest.

- The number of creditors in the Vienna Initiative was small and identifiable – namely European financial institutions. In contrast, Greek bond holders are more numerous geographically dispersed.

Figure 2. Comparison of Vienna Initiative Foreign Claims
End Q4 2010 in US$ billions

	European Banks	Rest of World	Total
Greece	136	9	146
Ireland	378	85	462
Portugal	195	8	202
Spain	632	76	709
Total	**1,341**	**178**	**1,519**
Cyprus	34	1	36
Malta	16	1	17
Slovakia	64	1	65
Slovenia	35	0	36
Bulgaria	34	0	34
Czech	179	4	183
Estonia	20	0	21
Hungary	108	9	117
Latvia	24	0	24
Lithuania	24	0	24
Poland	275	18	293
Romania	105	2	107
Serbia	25	0	26
Vienna Initiative	**944**	**37**	**981**
Vienna ex Poland	**669**	**19**	**688**

Source: BIS Quarterly Review Database (June 2011) and Center for Financial Stability Inc.

- Extension of a Vienna-type initiative to Greece might necessitate coverage of Ireland, Portugal, and Spain. Potential expansion of a Vienna Initiative to Greece, Ireland, Portugal, and Spain would require 42% more coverage than all 13 nations referenced in the Vienna Initiative. The exposure would be twice as high, if Poland were excluded from the Vienna Initiative nations.

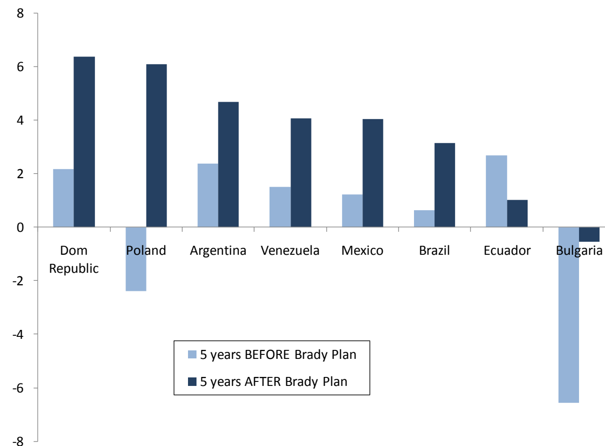
- Lastly, even if institutions roll maturing principal obligations, there is nothing to prevent financial institutions from withdrawing trade or other credits.

Debt Restructuring does not mean Economic Collapse

Debt restructuring or default does not mean economic collapse. In fact, a well orchestrated restructuring with Greek government ownership of a serious economic reform program will likely boost output and stimulate the economy.

Economic growth clearly benefits from debt reduction, as evidenced by the five year period after Brady Plan implementation. In seven of eight Brady Plan economies, the performance of growth improved in the five years after the Plan relative to the five years preceding implementation. In fact, the economies with the most aggressive reform programs such as Poland, Mexico, and Brazil demonstrated the sharpest improvements in output post debt restructuring.

Figure 3. Economic Growth Improvement Post Debt Reduction, Average Annual %



Note: Brady Deals include Mexico (1990), Venezuela (1990), Argentina (1993), Brazil (1994), Dominican Republic (1994), Bulgaria (1994), Poland (1994), and Ecuador (1995).
Source: Datastream, IMF and Center for Financial Stability Inc.

Ecuador was the only nation to demonstrate a worse economic performance after Brady Plan implementation, having sidestepped requisite reforms needed to strengthen the economy and market confidence.

A Brady Plan for Greece

A highly preliminary assessment of Greece's financial needs and potential suggests that debt reduction of 20% to 40% should be sufficient to simultaneously put the nation on a sustainable growth path as well as improve the nation's credit standing. The results are highly preliminary and based on the limited publicly available data.

Economic, financial, and official factors considered in this initial attempt to help design a restructuring framework suggest that resolution to the present Greek debt dilemma is possible.

On the **economic** front, reversal of three consecutive years of economic contraction is essential. The IMF Third Review under the Stand-By Arrangement contemplates a return to real growth of 2% to 3% on an annual basis over the next five years. Based on the present program and market conditions, achievement of this objective will likely prove difficult especially as the economy is projected to fall by 4% in 2011 after a 4.5% drop in 2010.

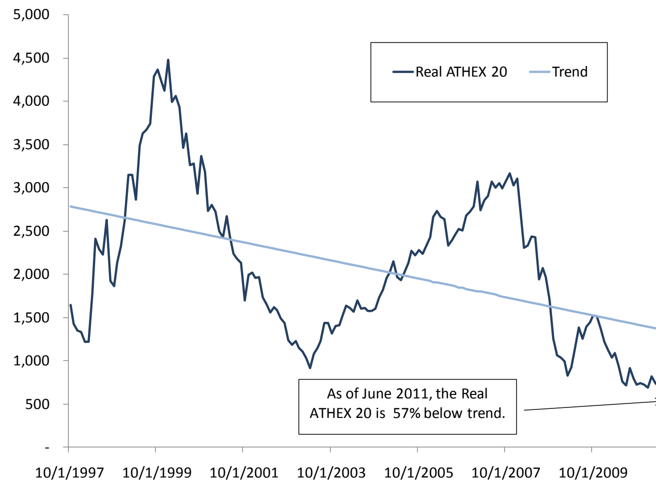
The objective of 2% to 3% growth over the medium-term is reasonable. However, economic reform and Greek ownership of the program will prove pivotal for success. Reform measures would include streamlined public spending and robust revenue collection as well as developing a meaningful privatization program.

The authorities would also be well advised to promote conditions for the repatriation of assets abroad. In the LDC Debt Crisis, the return of even the interest on the stock of capital residing in offshore banking

centers such as Miami, NY, London, and Zurich provided a powerful and relatively quick disbursing source of capital. The potential for capital reflow is meaningful.

To be sure, asset prices are inexpensive on a relative basis. We calculate the real value of the Athens stock market is roughly 57% below trend. These assets will rapidly become attractive, if the debt dilemma abates.

Figure 4. Real Value of Greek Equities and Trend



Source: Datastream and Center for Financial Stability Inc.

Based on our initial assessment, policies related to **finance** will clearly center on debt reduction. Policies include a targeted 20% to 40% reduction in the stock of debt and extension of any principal payments falling due through 2015. Stabilization of expectations surrounding medium and long-term debt should also facilitate the ready renewal of trade lines vital to fund imports and growth.

Figure 5. BIS Bank Exposure to Greece, US$ bn

	Foreign Claims	Derivatives, Guarantees & Commitments
Total	145.8	60.6
Europe	136.3	26.1
Non-Europe	9.5	34.5
France	56.7	8.3
Germany	34.0	5.9
Italy	4.1	1.7
Switzerland	2.9	1.5
UK	14.1	5.0
US	7.3	34.1

Source: BIS Quarterly Review Database (June 2011) and Center for Financial Stability Inc.

Foreign bank exposure to Greece is high. Hence, the fear of large losses in the international financial system persists in the wake of a reduction of Greek debt. Fears are warranted as European bank

exposure to Greece was $136.3 billion at the end of 2010, relative to a scant $9.5 billion in the rest of the world. Interestingly, European bank exposure to Greek entities via derivatives, guarantees and other commitments is lower at $26.1 billion. In contrast, US banks maintained exposure of $34.1 billion via derivatives, guarantees, and other commitments – despite a scant $7.3 billion in foreign claims.

Lastly, **official institutions and bilateral creditors** have an opportunity to act swiftly. Financial resources exist at the IMF and within the European Stability Mechanism (ESM). At present, more analysis is needed to determine whether those resources are more effective in the form of additional lending to the Greek government or supporting a successful debt restructuring program. Nonetheless, official institutions and bilateral creditors would likely be more effective channeling resources toward safeguarding the European financial system or providing the European Central Bank (ECB) with an added capital cushion.

Figure 6. Estimate of Greek Debt Reduction on European Banks

	Losses by banks (EUR bn)		Impact on capital	
	20%	40%	20%	40%
Europe	23.2	46.4	-1.1%	-2.2%
France	9.3	18.6	-1.9%	-3.8%
Germany	5.7	11.4	-1.5%	-2.9%
Italy	0.8	1.7	-0.2%	-0.4%
UK	2.7	5.4	-0.4%	-0.7%

Source: ECB, BIS Quarterly Review Database (June 2011) and Center for Financial Stability Inc.

Preliminary assessments of the impact on European financial institutions suggest losses will be large, yet a manageable EUR23.2 to EUR46.4 billion. French financial institutions are most heavily exposed with a potential reduction in capital of 1.9% to 3.8%.

Evidence from the Brady Plan would suggest a broader perspective beyond the direct provision of finance to the sovereign would be more durable and longer-term solution to the Greek debt dilemma.

Conclusion

- A solution exists to the Greek debt dilemma. However, an honest and analytic assessment by creditors and debtors alike is essential.
- Common ground must be sought and the responsibility for resolution must be shared.
- A restructuring of financial obligations in exchange for meaningful implementation of reform measures will ultimately make creditors, the debtor, and the populace better off.

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