

Investor lobbyism should be reigned in in the Greek debt case

A small camp in Berlin tries to fend off another looming fiscal disaster after the bank bailouts, likely in vain

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Angela Merkel has come under attack in the past weeks for showing allegedly excessive ambiguity over Germany's intention to provide 'help' to Greece, a country seeking to roll over her debt at more favorable interest rates than what the market offers to fend off a likely insolvency. There is even talk about an isolation of Germany in the EU by not jumping in as eagerly as France under M Sarkozy.

Yet, the struggle that is currently taking place in Berlin would be misinterpreted as heralding a new German special approach to the EU or the Eurozone. It simply reflects the growing and substantiated concerns that after just running through a hugely costly bank debt bailout program that is still not completed and has helped to raise government debt in developed countries by a full 20 percent, governments will be thrown into another debt spirale by being coerced to repeat the same in the sovereign debt arena.

In fact, the roll date for Greece come April 2010, however tiny the amounts by global capital market standards, is being sold from some corners to the global public as a remake of September 2008 when dozens of banks worldwide were unable to roll and had to tap government funds and guarantees. Those who have an interest to dramatize this scenario are the same as then: large banks and institutions with excess exposure to risky borrowers, then US mortgagors, now Southern European states, and even greater interest in hiding their managements' mistakes. Investors, to be sure, that include German government-owned Hypo Real Estate, who alone is reported to own 9 billion Euros in Greek debt.

Germany's choice is hence one between pest and cholera – recapitalizing parts of her financial industry once again, after having forked out already some 5% of GDP for bank recapitalizations and guarantees in the past 18 months, or rescuing the borrowers of that same industry. The discussion in the country has meanwhile moved from indifference to 'let the banks pay', a code for rejecting further intervention. For France, the situation is easier: her banks and insurers have been less affected by the US crisis and M. Sarkozy's main interest lies in protecting their good image and with some luck shifting some of their dud exposures to other shoulders. Adding up a half and a full incentive makes 1.5-0.5 in favor of a full Greek bailout between the two countries that used to be called the 'axis' of Europe.

Yet, at least some in Berlin in the finance ministry and its entours fear that the predictable outcome of this game, another rounds of bailouts, could easily become the worst of all worlds for taxpayers as it hands the financial industry the second major victory over government in just 18 months, after the Washington G20 meeting of November 2008 that basically nationalized all private debt of 'systemically relevant' banks.

In fact, rarely has a near-insolvency case such as Greece lent itself so easily to an objective restructuring solution of the kind that have been discussed at the international level for decades, the last incarnation being the IMF's proposal for a Sovereign Debt Restructuring Mechanism (SDRM) of 2003. A restructuring solution would assign a significant share of the loss to the existing creditors, in the Greek case mainly French and German banks and insurers. Yet, the losses would be subject to a floor via a government supported partial debt roll-over, preempting the market destabilization that followed Lehman.

Greece's government bond risk premia and CDS spreads already assume a significant loss ratio, the resulting 15-20% haircuts would be broadly in line with what the country can sustainably afford to service, in combination with the decline in interest rates resulting from lower debt levels. In a market context, i.e. absent willing rescuers such as today's IMF, bilateral EU arrangements and the still elusive 'EMF', serious restructuring negotiations would already have taken place. As things stand, both the borrower and her creditors rather than acting are simply speculating on a bailout.

It does not need to be emphasized much that a full bailout of the private creditors of Greece means a huge subsidy that would be funded with taxes in one form or another. An IMF bailout, for example, would mean a monetization of Greek sovereign debt via the ECB who backs up the Fund, i.e. a tax imposed on Eurozone savers. Bilateral arrangements would imply a rather direct tax burden.

Whatever the method, once a full bailout is established in sovereign finance in the Eurozone this provides massive incentives for other sovereigns and their financiers to push the debt envelope even farther. Rescuing Greece's old creditors in the interest of the public good would only make sense if those drawbacks, which are tantamount to a nationalization and in realistic scenarios monetization of the sovereign debt market, would be outweighed by a truly dramatic alternative. Yet, there can be no serious talking about such a drama when the issue is a simple debt restructuring.

We have examples for these in the form of Brady-Bonds issued by Latin American sovereign debtors of the 1980s that were guaranteed by the international taxpayer, however only with haircuts. The international financial institutions then also stepped in to provide fresh loans, senior in ranking to old bonds and loans, based on a sounder balance sheet to smoothen out the initial disturbances in the market once haircuts are imposed. Ken Rogoff's and many others' broadly favorable analysis of the Brady exercise inspired a large academic support, inter alia for the now stuck SDRM initiative. In the current bond market context that many characterize as a bubble created by zero interest rate policies, a Greek haircut exercise would mean merely a bump in the road, a badly needed cooling off. It is absurd to believe that the realization of what the market already expects in Greek interest rates, would lead to a bond market meltdown.

Yet, the presence of a formal sovereign quasi-insolvency procedure as the SDRM, while highly desirable, is not even necessary in the Greek case. All what it would take, or rather would have taken, is to help Greece to hammer out an agreement with her creditors, a difficult, but manageable endeavour for which German and French governments had the whole of 8 weeks time since the discussion started in February, until roll date in April. Instead of acting to attack the restructuring problem and protect taxpayers, both in the end will have spent their time with another round of protectionism of their large financial firms' special interests. Except that is, for small

**pockets of the German finance ministry that wanted to make a difference this time.
Should the Germans say again sorry for this?**