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A New Lease for Greece?

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Once again the Europeans find themselves scrambling to cobble together a solution for Greece. Once again the prescribed policy responses suggest a belief that the issue is one of liquidity rather than one of solvency. With a debt to GDP ratio approaching 160% and internal competitiveness within the Eurozone at 20 year lows, we believe that an honest assessment would conclude that Greece is, in fact, insolvent. In 1982, Mexico was the first significant domino to fall in what would become a chain of emerging markets nations defaulting on commercial bank loans. Mexico's debt to GDP at the time was approximately 60%, which compares favorably to the 160% figure in Greece. No amount of debt rollover, austerity or privatization is going to fix the fact that Greece owes more than it will be able to ever repay. The sooner that policy makers (in both Greece and the E.U. at large) admit to themselves and the public at large that this is the case, the better off everyone will be – most importantly the Greek population.

Recent reports suggest that European policy opinion is coalescing around a voluntary 70% rollover of maturing Greek bonds into new instruments that would either directly or indirectly fund Greece. The most prevalent stories suggest that 50% would be rolled into 30-year Greek bonds and 20% would be rolled into "AAA" rated securities, presumably guaranteed by the E.U., which would then lend the proceeds to Greece. The remaining 30% would end up as cash on the bank's balance sheet, reducing the nominal exposure to Greece. Based on the current market price of existing 30-year Greek bonds, we believe that this package is worth around 70 cents on the euro.

Rumored E.U. Rollover Template		
Rollover value	(50% rolled into 30-year Greece bond; price of 40)	20 cents
AAA Bonds	(20% rolled into AAA securities; price of 100)	20 cents
Cash out	(amount not rolled into the package; price of 100)	30 cents
Total recovery market value for each 100 cents face of Greek bonds		70 cents

The European solution is to rollover maturing securities and increase the demands for austerity while providing no nominal debt relief for Greece. In emerging markets, this has been tried in the past. It was termed the "Baker Plan" and it failed miserably. We expect the results to be the same within the E.U.

We believe that a better use of available resources can accomplish three tasks simultaneously:

1) Create a package of securities with similar values to the E.U. rollover option being proposed;
2) Provide meaningful debt reduction for Greece and place it in a position from which it can begin to grow and provide opportunity for its citizens; and
3) Offer the opportunity for bondholders to enjoy even higher recoveries if the Greek economy responds to less austerity, lower taxes, and economic reforms with higher than currently projected growth rates.

Modeled on the Brady plans of the 1980s and 1990s, we believe the solution will have the same effect that it did in emerging markets: create a sustainable fiscal position from which economic growth can resume.

Brady Style Debt Restructuring		
Rollover value	(100% rolled into 30-year bond; price of 100; 50% haircut)	50 cents
German zeros	(50% of original face, price of 34, paid for with E.U. funds)	17 cents
Cash out		0 cents
GDP Recovery Warrants		?
Total recovery market value for each 100 cents face of Greek bonds		67+ cents

This approach would reduce debt to GDP from 160% to 80% in one fell swoop. We make the simplifying assumption that a solvent Greece would see its bonds trading at a price of 100 instead of 40. Greece would still need to carry out effective economic and fiscal reforms to improve competitiveness, but with a lower debt burden, this becomes easier to finance with the resources no longer used for debt service. It would also open a path for Greece's eventual to return to market financing, something that is highly improbable under current E.U. plans. While the objective recovery value is somewhat lower than in the current E.U. template, it could be enhanced with well-designed GDP recovery warrants similar to those issued by Argentina. The proposed Brady-style plan also has a much higher probability of success. It should also be noted that the cost of the zero coupon bonds needed to facilitate the write-down of Greek debt would cost approximately EUR 60b, well below the amount of the current aid package being proposed. Some may complain that this is a back-door bailout of the European financial system, and perhaps with reason. However, holding to principle during a time when an accident in Greece is increasingly likely to cause a multi-car pile-up involving several other sovereigns is not the best course of action. Greece is currently *unable* to pay its debt in full without support from the E.U. We are rapidly approaching the point where the Greeks will be *unwilling* to pay in full. The time for Plan B is now…

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