

GLOBAL ECONOMICS January 19, 2012, 6:30 PM EST

A Greek Default: It's a-Comin'

Talks are under way, but settlement options look a lot like—a default

By [Peter Coy](#) and [Matthew Philips](#)

Negotiations over how to shrink Greece's unaffordable government debt make the brinkmanship over the U.S. debt ceiling last summer look simple. In the U.S., almost everyone agreed that default would be disastrous. In Greece, default is probably unavoidable. The battle is over whether it happens gently, in what is known as a "consensual restructuring," or chaotically, in what is known as "all financial hell breaks loose."

What makes the standoff over Greece so dangerous is that the players aren't just dug into two opposing positions, as the White House and the Tea Party were. There are multiple battle fronts—and even fighting among supposed allies. "I can only tell you the negotiations are continuing," says Frank Vogl, a spokesman for the Institute of International Finance, which represents private creditors. "I can't tell you whether they'll be successful."

Unless official lenders come to the rescue, it appears likely that Greece will default on Mar. 20, because it simply doesn't have the €14.4 billion (\$18.5 billion) that it owes bondholders on that date. "It is just a matter of time before the whole house of cards falls apart," says Robert L. Rauch, a partner at Gramercy, an emerging-market investment manager in Greenwich, Conn.

The debt negotiations, which resumed on Jan. 18 after a five-day hiatus, address how to reduce what Greece owes in a way that spreads the pain fairly. If no deal is cut in time and the default is disorderly, the health of some of Greece's creditors could come into question, possibly spreading panic.

The private bondholders include most of Europe's big banks, such as BNP Paribas, ([CBK:GR](#))Commerzbank, ([DB](#))Deutsche Bank, and ([ING](#))ING, as well as pension funds and hedge funds. The investors' negotiating positions differ depending on the price they paid for their bonds, their ability to survive a loss, and the hedges they have purchased. Hedge funds are likelier to have hedges in place and are less pressured to do the bidding of their national governments than the banks are, giving them an incentive to push hard. But their leverage is limited because they own "a very small percentage" of bonds, says Julie Chon, a former senior policy adviser to the Senate Banking Committee.

The optimistic take is that the risk of a meltdown is so great it will force the far-apart negotiators to compromise. "I'm highly confident the deal will get done," Bruce Richards, the chief executive of \$10 billion hedge fund Marathon Asset Management, said in a Jan. 17 interview. Marathon is on the creditors' committee but not the steering committee directly involved in negotiations. Richards predicts that Greece will miss its Mar. 20 payment, but with a deal in place that gives bondholders a market value of about 32 percent of their bonds' face value in cash and new securities.

One sticking point is that the better the deal that private creditors get, the more likely that Greece won't be able to afford it, and will have to ask the euro zone governments or the International Monetary Fund for more help.

That's where the internal conflicts come in. The big European banks that own lots of Greek bonds would like any new bond issued in a deal to pay high interest rates. But they must also consider the interests of their governments, which want Greece to pay low interest rates so it won't need more aid from the European Union and its paymaster, Germany. On the other hand, a too-generous deal might lure Portugal and others to ask for the same.

Credit default swaps further muddy the waters. The restructuring is being designed in hopes of not falling under the technical definition of a default. But anyone at the negotiating table who has purchased protection through swaps might want to push Greece into a technical default to trigger payouts on the swaps. That trigger would hurt some European banks that not only bought bonds but amplified their exposure by selling default protection to others. That risky strategy is jokingly known as a "Texas hedge"—i.e., not a hedge at all. Richards of Marathon declined to discuss whether his hedge fund has bought default protection—and noted that he is pushing for completion of a deal.

Even the Greek government itself has multiple objectives. It wants to reduce its debt as much as possible. Prime Minister Lucas Papademos told the *New York Times* in an article published on Jan. 18 that the country would consider passing a law to require holdouts to take losses if they balk. Yet Papademos knows that if Greece burns its creditors too badly, it will have even more trouble borrowing in the future. A deal is likely to come down to the wire.

The bottom line: Negotiations over a “consensual restructuring” of €205 billion in Greek bonds are complicated by the mixed motives of the parties.

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