Greece’s new bail-out helps, but should have gone further

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WHEN Henry Paulson, America’s then treasury secretary, readied a plan to prop up Fannie Mae and Freddie Mac, two teetering housing agencies, in the summer of 2008, he spoke of having a “bazooka” in his pocket. In their response to the sovereign-debt crisis, Europe’s policymakers have tended to favour the peashooter. Their latest salvo in defence of Greece on July 21st produced some favourable initial reports, but the bang has faded. In a strange inversion of the crisis to date, the new bail-out plan seems to have helped the weaker peripherals and hurt the stronger ones.

The latest Greek bail-out consists of two main elements. The first is the promise of an extra €109 billion ($158 billion) in official lending to Greece from other members of the euro zone (apart from Ireland and Portugal) and the IMF. Greece will get more time to repay its loans; Europe is also cutting the interest rate it charges Greece, to about 3.5% from 5.5%. In effect, the euro zone is allowing Greece, its flakiest member, to borrow at rates similar to those paid by Germany, its most creditworthy one.

The second element of the plan involves asking Greece’s private creditors to shoulder some of the rescue burden. Bondholders are being asked to choose from a bewildering menu of options under which they can sell bonds at a discount or swap them for 15- or 30-year bonds, either now or when they mature. Under the proposals, which were negotiated with the Institute of International Finance (IIF), a club of the world’s biggest banks, €135 billion in Greek bonds are meant to be exchanged between now and 2020. Combined with official support the plan could allow Greece to steer clear of bond markets for the rest of the decade.

The IIF reckons the plan will cut the value of the bonds held by banks and insurers by 21%. That number is a little misleading: the plan neither reduces Greece’s debt burden to private-sector creditors by 21% nor does it necessarily imply a 21% write-down on the value of the debt by those who hold it. The menu of options seems to have been tailored to suit the accounting regimes of various creditors. Some holders of Greek debt may even be able to write its value back up as a result of the deal. “Now the negotiations are with the auditors,” says a banker who was close to the talks.

These accounting debates could mean the difference between all of the equity in the Greek banking system being completely wiped out (and a recapitalisation of €10 billion-15 billion from the bail-out pot) and more manageable hits to capital of €3 billion-6 billion. “The package is on balance pretty good for the Greek banks, although shareholders could be diluted down by 30-50% if the accounting treatment is harsh,” says Alexander Kyrtsis of UBS.

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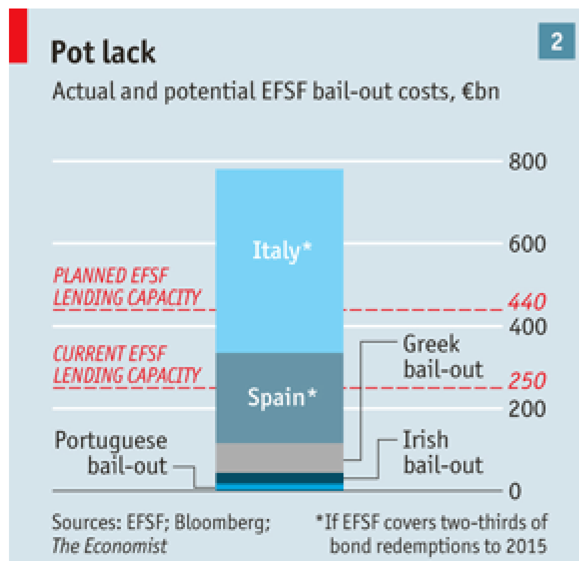
Although European leaders no longer seem too bothered about avoiding a verdict of default from the ratings agencies, signing up to the plan is still "voluntary" in order to avoid payouts on credit-default swaps. The IIF is targeting a participation rate among Greece's creditors that would affect 90% of the country's privately held debt. Such participation rates have been achieved on similar swaps in the past—Uruguay reached 93% participation in a 2003 exchange—but mainly because the alternative seemed to be certain default.

In the case of Greece, smaller investors with soon-to-mature bonds may be tempted to hold out if they reckon Europe's leaders wouldn't dare impose a forced restructuring. Even so, enough big institutions seem to have signed on to get close to the 90% figure, according to senior bank executives involved. "Institutions are big enough and connected enough that they can see the big picture," says one. "Whether they were subject to enough political pressure or it was from enlightened self-interest, both arrows point in the same direction."

The second bail-out will improve Greece's debt burden, although improvement is an elastic concept. The new package will stabilise Greek debt at about 150% of GDP over the next ten years (see chart 1), according to Barclays Capital. Many assume that a third bail-out or another restructuring will be needed to reduce Greece's debts to 80-90% of GDP, although some are more sanguine. "There is at least a fighting chance now that there won't be another bail-out," says Gilles Moec of Deutsche Bank. In cutting the interest rates paid by Ireland and Portugal on their bail-outs, the new rescue package also reduces the risk that these two economies will need more help. Ireland reckons it will save €900m a year on interest payments, for instance. Irish and Portuguese bond spreads came down after the summit (although Cyprus, whose banks are heavily exposed to Greek debt, is heading the other way).



The plan allows the European Financial Stability Facility (EFSF), the euro zone's bail-out fund, to offer precautionary lines of credit to countries that are not yet on life support, and to recapitalise their banks. Given that most investors worry about Spanish banks more than about the Spanish government, that may help the country insulate itself. But the EFSF's new powers still need to be ratified, and its lending capacity, currently €250 billion and soon to be €440 billion, was not expanded. It would be stretched if Spain really lost the confidence of markets, overwhelmed if Italy did (see chart 2).

The region's bigger bond markets remained unsettled this week (America's debt-ceiling wrangle will not have helped, of course). The spreads, or extra interest, paid by Spain and Italy to borrow compared with Germany inched back towards their highest levels in more than a decade. American money-market funds, an important source of short-term borrowing for European banks, are stealing away. Banks are losing their nerve: Deutsche Bank has cut its net exposure to Italian government debt to less than an eighth of its 2010 level, mainly by insuring against default.

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So are governments. Italy has cancelled a scheduled auction of long-term debt in mid-August, saying it doesn't need the money (and, anyway, most people are on the beach). Bond traders think it was more about avoiding a poor result. "We would have preferred the auction to go ahead," says one senior Italian banker, who frets that postponement has rattled nerves. More weaponry looks necessary.