Buenos Aires to Athens: The Road to Perdition

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Main Points

- Three sovereign defaults in the past decade have each inflicted losses of at least 70 percent on bondholders—Argentina, Ecuador, and now Greece.
- In each case, creditor rights and the rule of law were trampled, setting troubling precedents that are worrying investors involved in vulnerable European countries.
- In Argentina (in default since 2002), numerous arbitrary measures were taken that damaged the interests of investors; the debt relief that was demanded bore little relation to the country's capacity to pay; and court judgments and arbitral awards against the sovereign have been routinely ignored.
- Ecuador (2008–2009) stands as the clearest example of sovereign unwillingness to pay. Investors were blindsided, bullied, and then sacrificed as part of a personal and ideological vendetta on President Correa's part.
- Investor confidence in Greece was destroyed by persistently negative attitudes coming out of Berlin. The huge losses imposed on creditors were based on questionable estimates and judgments, and various troubling, expedient means were used to achieve the dubious ends.

The recent debt restructuring in Greece, which imposed up-front losses of about $130 billion on bondholders (mainly European banks), and all-in losses of more than 70 percent on a net-present-value (NPV) basis, is actually the third time in the last decade that a sovereign workout (1) has been driven largely by political considerations and (2) has led to an erosion of international creditor rights and the rule of law.

The road to perdition for investors starts out in Buenos Aires (in default since 2002), winds its way through Quito (2008–2009), and has now reached Athens in 2012. Time will tell where it will be extended next—most likely, within Europe. The lesson is that while government bonds are usually low-risk investments, especially relative to corporate bonds and complex structured securities, on occasion these obligations are perverted or ignored by governments lacking in ability or willingness to pay. Each of these rare instances sets a troubling precedent worthy of reflection.

The Argentina Precedent

The government of Argentina announced in late December 2001 that it would be defaulting on its public debt, and a couple of months later it abandoned its fixed exchange-rate regime (where one peso was equal to one U.S. dollar), allowing its currency to devalue massively. In the three and a half years prior to the default, the country had been undergoing deflation (or an "internal devaluation") comparable to that which Greece is now experiencing: Argentina's real GDP dropped 15.7 percent from 2Q98 to 4Q01. The economy would go on to fall an additional 4.5 percent in the wake of the default and devaluation, for a GDP collapse of nearly 20 percent between mid-1998 and mid-2002. The urban unemployment rate increased more than 8 percentage points during that period, from 13.2 percent to 21.5 percent of the labor force. However, Argentina's economy would soon bounce back courtesy of booming commodity prices and an export-led recovery, with GDP returning to its 2Q98 level by 1Q05 and the unemployment rate falling back down below 13 percent even quicker than that.[1]

[1] Seasonally adjusted quarterly GDP data from the Dirección Nacional de Cuentas Nacionales, INDEC, and unemployment rates from the Encuesta Permanente de Hogares, INDEC. Real GDP

As to the Greek economy, it has already shrunk by about 20 percent since peaking in mid-2008, and even the IMF is projecting that it will contract by almost 6 percent more between this year and next. The unemployment rate has soared by nearly 14 percentage points already, from 7.2 percent in mid-2008 to 20.7 percent in 4Q11.[2] This relatively deeper downward spiral in Greece than in Argentina is consistent with the insights of economic theory and the findings of empirical studies, namely, that in the absence of any exchange-rate flexibility, all necessary economic adjustments have a more pronounced effect on output and employment than would be the case otherwise. The grave problem lies in the way the default on some $90 billion in obligations to bondholders and other creditors was handled in Argentina—back in 2002 and through today.

First, a number of arbitrary measures were taken just before and right after the default and devaluation that complicated the resolution of the country's crisis. Bank deposits were frozen; capital controls were imposed; the application of bankruptcy and foreclosure laws was suspended; selective price controls were enacted; contracts allowing for utility price increases in the event of currency devaluation were broken; and dollar-denominated assets and liabilities were forcibly converted into pesos at different exchange rates to the benefit of debtors—including the government—and the detriment of banks, depositors, and ultimately taxpayers.[3]

These initial measures have been modified through the years, but they offered a preview of what has become a decade of heightened government nationalism, interventionism, and paternalism—populist policies that would make the late General Juan Perón proud, but that are tenable only as long as Argentina continues to benefit from high prices for its commodity exports.

Second, while other sovereigns in financial trouble—including Argentina itself in the past—sought to avoid a default, all post-2001 administrations in Buenos Aires have been uncooperative and indeed defiant in their approach to creditors. It took them three years to put forth a unilateral, take-it-or-leave-it offer to restart payments to bondholders, and when they did (in early 2005) it was contingent on creditors accepting massive losses, estimated at more than 70 percent on a net-present-value (NPV) basis.[4] Coincidence or relevant precedent, it happens to be the same degree of punishment just delivered by Greece to its own bondholders, as mentioned at the outset.

Adding insult to injury, Argentina refused to recognize most of the interest arrears that its own delay had generated, not to speak of treating the arrears preferentially; failed to include an upfront payment to clear a portion of the arrears, a common "sweetener" to ensure success; was not accompanied by the usual reassuring endorsement—never mind financial support—from the IMF or other multilateral agencies; and did not aim for universal acceptance in order to bring the default episode to a conclusion. To intimidate its creditors into submission, the government had the legislature pass a law forbidding any future reopening of the debt exchange as well as any potential payment to holdouts even if arising from a court order (the "Lock Law").[5]

Third, the enormous debt forgiveness Argentina demanded bore no relation to the country's enhanced—and fast-improving—capacity to pay. While the government's debt burden in relation to GDP had soared from 54 percent in 2001 to nearly 170 percent in 2002 in the wake of the ballooning of Argentina's foreign-currency debt post-devaluation, it had already dropped below 130 percent by 2004 and was headed to double digits on its own. Given an intervening boom in government tax revenues and a recovery in official international reserves to above $20 billion, Argentina's demand for such massive debt relief was unjustified. Previously, such extent of debt forgiveness had been granted by bank creditors only to desperately poor countries like Niger in 1991, Bolivia in 1992, Albania in 1995, Guyana in 1999, and Yemen in 2001.[6]

As a result, the 2005 debt restructuring attracted a mere 76 percent of bondholders, the lowest participation rate by far compared to other sovereign workouts. While many investors decided to pass on this restructuring in the hope of a better offer from Argentina in the future, others headed to courthouses in New York and various venues in Europe, obtaining dozens of court judgments in their favor

nowadays stands more than 60 percent higher than it did back in 2Q98, and the unemployment rate has stabilized below 7.5 percent.

[2] Non-seasonally adjusted quarterly GDP and unemployment data from the Hellenic Statistical Authority; IMF GDP projections from "Greece: Preliminary Debt Sustainability Analysis," February 15, 2012, table 2.

[3] IMF, "Lessons from the Crisis in Argentina," October 8, 2003.

[4] Juan J. Cruces and Christoph Trebesch, "Sovereign Defaults: The Price of Haircuts," *CESIFO Working Paper #3604*, October 2011, p. 30. The authors summarize various alternative calculations of investor NPV losses generated by them and other experts, and they average 74 percent.

[5] Arturo C. Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default," *Chicago Journal of International Law*, Summer 2005.

[6] Ibid.

involving billions of dollars in claims for principal and past-due interest.

At the same time, a number of multinational companies headed mainly to the International Center for Settlement of Investment Disputes (ICSID), the world's premier dispute-resolution center (and part of the World Bank Group), to file claims against Argentina for breach of contract, taking advantage of the protections offered by various bilateral investment treaties. At present, there are 25 cases against Argentina winding their way through the ICSID arbitration process, and 24 cases have been concluded—the most claims ever filed against a single country.

The government's attitude toward both court judgments and arbitral awards against it remains one of contempt: as far as is known, no payments have been made, even after routine appeals, annulment procedures, and stays of enforcement have run their course.[7]

In early 2010, the government reopened its 2005 debt exchange and a number of holdout bondholders capitulated, accepting the steep losses and new long-term bonds offered by Argentina.[8] The authorities did so despite the fact that the country's economic circumstances were vastly improved, with the debt-to-GDP ratio down to around 50 percent and official international reserves up to a high of more than $50 billion.

By now, about 92 percent of bondholders have tendered their old, defaulted bonds, either in 2005 or in 2010. But the remainder, who are owed more than $15 billion (including accrued and penalty interest), now constitute a hard core of unpaid creditors. They are pursuing every remedy legally available to enforce their claims. That is why Argentina has been unable to return to the international bond markets: there are creditors waiting to block any such issuance until they are paid what the courts have agreed they are owed.

Argentina has also not cured its decade-long default on debts to the Paris Club of official bilateral lenders (export credit and foreign aid agencies), who are owed close to $8 billion, of which about $7 billion is in arrears. The Argentine authorities have repeatedly stated their intention to negotiate with the Paris Club and to reach a rescheduling agreement. But they have balked at the requirement that the IMF pass judgment on the justification for any debt relief, so much so, that Buenos Aires has shut its doors to the Fund, refusing to abide by its treaty obligations which include allowing the IMF to inspect its books and evaluate the country's economic performance and policies under a so-called Article IV consultation.

The IMF is supposed to hold bilateral discussions with its member governments annually, but Argentina has not hosted the IMF since 2006. Moreover, the IMF has repeatedly questioned the veracity of official inflation and GDP statistics published by the Argentine government, as have numerous private-sector economists inside and outside the country. Member governments are obligated to furnish reliable data to the IMF under Article VIII, Section 5, of its Articles of Agreement.[9]

In sum, the case of Argentina sets a number of troubling precedents in terms of how a sovereign in temporary financial difficulties ought to behave in order to obtain needed debt relief. One would have to recall the 1930s before finding another country that lost its way in the international capital markets for as long as has Argentina—a cautionary tale of the downside of mistreating investors.

The Ecuador Precedent

In mid-November 2008, the government of Ecuador made it known that an upcoming coupon payment on a sovereign bond maturing in 2012 would not be made on time, and a formal default on the country's foreign debt was declared (on December 12) before the 30-day grace period was up. Soon after, it was announced that an upcoming interest payment on another sovereign bond, this one due in 2015, would likewise not be made. President Rafael Correa would justify the country's moratorium on the basis that Ecuador's foreign debt obligations were "immoral," "illegal," "illegitimate," or all of the above.

Yet as the weeks and months passed, it became apparent that Ecuador's default would be highly selective, and that it would lead neither to a repudiation of obligations nor to a negotiated or even unilateral debt exchange (Argentine-style) for the purpose of obtaining massive debt forgiveness. The default was confined to two of the country's sovereign bonds: the one maturing in 2012 and

[7] For background on ICSID proceedings involving Argentina, see Eric David Kasenetz, "Desperate Times Call for Desperate Measures: The Aftermath of Argentina's State of Necessity and the Current Fight in the ICSID," *George Washington International Law Review* 3 (2010).

[8] The supposedly ironclad "Lock Law" was temporarily suspended by an act of the Argentine legislature to permit a reopening of the 2005 debt exchange.

[9] See "Argentina's Inflation Problem: The Price of Cooking the Books," *The Economist*, February 25, 2012, and for additional background Arturo C. Porzecanski, "Should Argentina be Welcomed Back by Investors?," *World Economics*, September–December 2011.

another due in 2030, both of which accounted for nearly one-third of the external public debt as of end-2008. The other two-thirds of the foreign debt were spared. Indeed, in mid-January 2009, the government surprisingly decided to pay the coupon on the 2015 bond just before its grace period ran out, saying that its nature was different—evidently, it was moral, legal, and/or legitimate when compared to the other two bonds.

The 2012 and 2030 bonds were themselves born out of an earlier sovereign default that took place in August 1999. In July of 2000, Ecuador had issued them in exchange for existing obligations to which major reductions in principal or interest payments were applied, such that the resulting debt relief entailed an average NPV (net present value) loss to creditors on the order of 34 percent.[10] Some 97 percent of all bondholders accepted that exchange offer, giving Ecuador substantial debt forgiveness as well as significant cash-flow relief in the initial years. The 2015 bond, in contrast, was the product of a voluntary market transaction that took place at the end of 2005.

The way the Correa administration dealt with the two "questionable" sovereign bonds was to buy them back from investors, indirectly at first and then directly, paying cash for a fraction of their face value (or rather, their pre-default market value), for the purpose of extinguishing them. The government reportedly began to purchase the 2012 bonds in the secondary market after their price collapsed following the mid-November 2008 decision to default on them, using an Ecuadorian bank as the front man. It allegedly continued repurchasing its securities after defaulting on the 2030 bond, such that by one estimate, the government picked up as much as half of the two bond issues in this backhanded manner.[11]

Then, on April 20, 2009, the government announced a buyback offer to repurchase the remaining bonds in private hands through a modified Dutch auction with a base price of 30 cents on the dollar. A disclosure document circulated at the time set an expiration date of May 15 for all offers, and it made plain that Ecuador had no intention of resuming payments on the two bonds after that date. In the event, 91 percent of the bonds outstanding were tendered, including those in government hands, and an additional 4 percent were handed in after an extension was granted, enabling the government to retire nearly $3 billion in bonds for around $900 million in cash payments. The resulting hit to investors was an average NPV loss on the order of 68 percent.[12]

Ecuador's 2008–2009 default was a clear case of unwillingness to pay. At no point before or after the default did the government assert that servicing the two bonds posed a financial hardship. There was no objective basis for doing so: in 2008, the public external debt was the least burdensome it had been in over three decades, relative to government revenues or to GDP (less than 20 percent, down from 70 percent of GDP in 2000). Moreover, the country's central bank held more freely disposable international reserves ($6.5 billion) than it had ever accumulated before.[13]

Fifteen months after the default, the finance minister would herself confirm that it had not been prompted by any economic difficulties.[14] Two renowned attorneys wrote, "It was the first time in modern history that a sovereign debtor had demanded that its external commercial creditors write off most of their claims . . . without advancing a plausible argument that financial distress warranted such extraordinary debt relief."[15]

The motivation for the default was an alleged ideological and personal vendetta by President Correa. In 2003, Correa had been retained by the government as an economic adviser on the issue of how to set up and pay for a universal health-care system in Ecuador. At the time, funding for social programs was limited because oil export prices were low (around $25/barrel), and oil-related revenues that might otherwise be available were being deposited into a government fund to generate the savings necessary to redeem the 2012 and 2030 sovereign bonds.

When Correa was appointed finance minister in 2005, he wasted no time in proposing to the legislature the abolition of the fund and the setting up of an alternate one to underwrite largely social spending—an initiative that prospered. And then, at his inaugural address as president in January 2007, Correa announced that his administration would engage in a "firm and sovereign

[10] Cruces and Trebesch, "Sovereign Defaults," p. 30, average of various alternative calculations.

[11] This and the following paragraphs borrow heavily from Arturo C. Porzecanski, "When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador," *Law & Contemporary Problems*, Fall 2010.

[12] Cruces and Trebesch, "Sovereign Defaults," p. 30, average of two alternative calculations.

[13] Even though Ecuador's revenues and GDP dropped somewhat in 2009 in the aftermath of the global recession, the burden of interest payments on the 2012 and 2030 bonds (a mere 1.9 percent of 2008 government revenues and 0.6 percent of 2008 GDP) would not have risen appreciably in the absence of a default.

[14] See Ministerio de Finanzas del Ecuador, "La Moratoria de los Global 2012 y 2030 Fue por Ilegitimidad y No por Falta de Recursos," Press Release #007, March 4, 2010.

[15] Lee C. Buchheit and G. Mitu Gulati, "The Coroner's Inquest," *International Financial Law Review*, September 2008.

renegotiation of the external debt, above all of the inadmissible conditions that were imposed on us in the debt exchange of 2000."[16]

President Correa soon appointed a commission to carry out an audit of the domestic and foreign public debt chaired by his first finance minister, Ricardo Patiño, plus others from his administration and a number of civil-society representatives with a long history of militancy in the debt-forgiveness or debt-repudiation movements. Patiño would later have to resign from this cabinet post and the commission because of a scandal involving the alleged manipulation of Ecuador's bonded debt—an omen of what would follow.[17]

The commission's report appeared to be written in haste, without the benefit of having hired professional auditors, interviewing past finance ministry officials or former presidents, or gaining access to many important documents. It concluded that much of Ecuador's debt was tainted by illegality and illegitimacy, and involved instances of profiteering, excessive conditionality, lack of transparency, abuse of authority, and multiple other irregularities.

The debt audit commission apportioned blame to foreign commercial and investment banks, official bilateral and multilateral lenders, the U.S. Federal Reserve (for "illegally raising interest rates"), former government officials, the country's own central bank, foreign and domestic legal counsel, and so on. Interestingly, Ecuador's three outstanding sovereign bonds were all denounced equally.[18]

President Correa received the commission's final report in November 2008, but by then he had already ordered that payment on the next coupon of the 2012 bonds be skipped. He embraced the report publicly to justify the default, yet he went on to cherry-pick from its conclusions and, as pointed out earlier, decided to keep on servicing two-thirds of the public foreign debt—plus all of the government's domestic obligations—penalizing only the bondholders he had meant to target all along.

[16] Presidencia de la República del Ecuador, "Discurso de Posesión del Presidente de la República, Econ. Rafael Correa," January 15, 2007.
[17] "Ecuador: Caught on Camera," *The Economist*, July 26, 2007. Patiño has remained in Correa's cabinet as minister of foreign affairs.
[18] Internal Auditing Commission for Public Credit of Ecuador, *Final Report: Executive Summary*, November 2008. The proceeds of the 2015 bond issue had been devoted by a prior administration to repurchase a portion of the 2012 bonds, in accordance with a commitment made at the time of the 2000 debt exchange. Because of this, the 2015 bond could have been regarded by President Correa as guilty by association.

He never appealed to the "odious-debt" doctrine (that national debt incurred by governments that do not serve the interests of the people are not enforceable) or any other grounds for repudiation—and with good reason, because Ecuador has been under continuous civilian, constitutional rule since mid-1979, and virtually all of the build-up in foreign public indebtedness had taken place subsequently.[19] Issues of state succession, war-related debts, widespread corruption, the absence of informed consent, or collusion on the part of creditors to divert funds for contrary purposes—none of these potentially relevant criteria for an odious debt argument were applicable, and Correa evidently realized it. Indeed, the irony is that his government ended up spending a tidy sum buying back supposedly immoral, illegal, and/or illegitimate obligations —and in so doing, validated them.

Ecuador's 2008–2009 default and bond-market manipulations mocked creditor rights and the rule of law. By taking a variety of deliberate actions to depress the value of their bonds and then repurchasing them at rock-bottom prices, the authorities in Quito became the principal beneficiary of their own default. The government concealed at the time, and has yet to reveal, the extent of its true beneficial ownership of the sovereign bonds tendered into the May 2009 buyback auction. That frustrated the protections in the trust indenture that governed the two securities, because they specified that bonds owned or controlled by Ecuador should not have counted for the purpose of any collective action.[20]

The impression conveyed by authorities was that Ecuador's bondholders were participants in a "voluntary" restructuring process, when in fact they were the likely victims of an elaborate deception. A veteran financial reporter commented at the time that since the bondholders had no say whatsoever in the destruction of the value of their investments, their only "choice" was whether to accept Ecuador's offer or hold onto defaulted Ecuadorian paper indefinitely.[21] This was the dilemma that investors faced particularly after having witnessed how Argentina had managed to frustrate attempts to be held accountable for its default in the foreign courts of law and arbitration tribunals that had jurisdiction.

[19] The greatest build-up in foreign public indebtedness took place from 1980 through 1994, when the sum total of Ecuador's obligations (including arrears) skyrocketed from less than $3 billion to nearly $14 billion, tripling even in relation to rising government revenues and GDP.
[20] Buchheit and Gulati, "The Coroner's Inquest."
[21] Felix Salmon, "Is the Obama Administration Condoning Ecuador's Default?," Reuters, May 18, 2009.

In sum, Ecuador's case set a number of additional precedents, the most important being that sovereign unwillingness, and not just inability, to pay contracted amounts can be the source of a default—despite the protections contained in elaborate bond indentures—and that sovereigns can engage in market manipulation and behave in unprincipled ways without fear of prosecution. Notwithstanding the best of legal contracts and the usual surrender of sovereign immunities under foreign laws, in actual practice, rogue debtors can be held accountable or effectively restrained only by the forceful actions of other sovereigns. If the government of Ecuador has faced any penalty for its misbehavior in 2008–2009, it is that it has not been welcomed back to the international capital markets, but so far President Correa has not minded, preferring to rely instead on loans mainly from China.[22]

The Greek Tragedy, Act I

The pedestrian narrative about the Greek financial crisis and default is that the country was fiscally mismanaged for a long time and failed to carry out needed structural reforms that could have improved economic growth prospects and enhanced the country's creditworthiness. Therefore, a default and debt restructuring were inevitable sooner or later—and certainly so once the financial markets were informed, as happened in October 2009, that prior governments had underestimated their budget deficit and public debt figures. The prosaic tale of the supposed inevitability of the Greek tragedy has been endorsed, for example, by a prominent economic historian: "Since independence in the 1830s, Greece has been in a state of default about 50 percent of the time. Does that tell you something?"[23]

In reality, Greece's road to default and debt restructuring in 2012 was not at all straightforward—and there was no historical inevitability about it, either. Consider some of the facts. In the last five decades, successive governments in Greece managed their public finances without a hitch, including servicing a very high level of public debt that averaged the equivalent of nearly 100 percent of GDP from 1990 until 2009.[24] In 2009, the public debt was structured very favorably: the average interest rate on the debt was a low 4.2 percent, and its weighted-average residual maturity was 8 years, the second-longest among advanced economies (after the United Kingdom)—despite the eurozone's no-bailout pledge.[25]

It is true that Greece raised eyebrows in October 2009, when an incoming government announced that the fiscal deficit for 2008 had been revised from the equivalent of 5 percent to 7.7 percent of GDP, and that because of an election-related drop in tax revenues and a splurge in fiscal spending, the deficit for 2009 would end up closer to 12.5 rather than 3.7 percent of GDP. (In the event, the actual figures were 6.5 percent and 15.8 percent of GDP, respectively.) It is also the case that the incoming prime minister promised at the time to impose austerity measures, but that he was short of convincing detail and political support.

However, Greece was the rule rather than the exception: every one of the 17 member countries of the eurozone experienced a major fiscal deterioration between 2007 and 2009 as a consequence of Europe's economic downturn. While Greece's fiscal deficit widened by 9.3 percentage points of GDP during the two years, the fiscal position of the eurozone as a whole widened 5.7 percentage points. Britain's own 2009 budget deficit was equivalent to 11.3 percent of GDP.[26]

And largely because of the added fiscal cost of various bank bailout plans, the ratio of government debt to GDP increased by 13.5 percentage points in the whole of the eurozone between 2007 and 2009, and a more limited 5.6 percentage points in Greece. (In the United Kingdom, meanwhile, it jumped by more than 25 percentage points of GDP.) Among other heavily indebted countries in the eurozone, the ratio of debt to GDP went up as much as 11.8 percentage points in Belgium and as little as 2.7

[22] Many of the loans are backed by or related to crude oil exports to China, and "[f]or Ecuador and Venezuela, the large influx of Chinese lending has served as a key source of foreign finance" that has compensated for lack of access to the international bond market. See Kevin P. Gallagher, Amos Irwin, and Katherine Koleski, *The New Banks in Town: Chinese Finance in Latin America*, Inter-American Dialogue, March 2012, pp. 7–8.

[23] "Q&A: Carmen Reinhart on Greece, U.S. Debt and Other 'Scary Scenarios,'" *Wall Street Journal Blogs*, February 5, 2010. This is reminiscent of skeptical attitudes among academics toward Mexico's financial crises at the end of seemingly every six-year presidential term—at least until a dozen years ago, that is, when Mexico "outgrew" them.

[24] IMF, *Historical Public Debt Database*, September 2011. The precise two-decade average was 99 percent of GDP. The government of Greece defaulted on its obligations during the Great Depression, as did some 30 other governments around the world, more than a fifth of total sovereign issuers, and the default was finally cured in 1964. See Standard & Poor's, "Sovereign Defaults at 26-Year Low, to Show Little Change in 2007," September 18, 2006.

[25] Average implicit interest rate calculated by the author from Eurostat, *Government Finance Statistics, Summary Tables 1996–2010*, December 2011, p. 13; maturity data from IMF, *Fiscal Monitor*, November 2010, pp. 27–32.

[26] Unless otherwise noted, all fiscal data cited here and appearing in the nearby table are the author's calculations from Eurostat, *Government Finance Statistics, Summary Tables 1996–2010*.

Selected Fiscal Indicators	**2007**	**2009**	**Change**
Fiscal balance/GDP			
Eurozone	**-0.7**	**-6.4**	**-5.7**
Belgium	-0.3	-5.8	-5.5
Italy	-1.6	-5.4	-3.8
Greece	-6.5	-15.8	-9.3
Govt. Debt/GDP			
Eurozone	**66.3**	**79.8**	**13.5**
Belgium	84.1	95.9	11.8
Italy	103.1	105.8	2.7
Greece	107.4	113.0	5.6
Govt. Debt/Eurozone GDP			
Belgium	3.1	3.7	0.6
Italy	17.7	19.7	2.0
Greece	2.6	3.4	0.8
Govt. Debt/Eurozone Govt. Debt			
Belgium	4.7	4.6	-0.1
Italy	26.7	24.7	-2.0
Greece	4.0	4.2	0.2

percentage points in Italy. The eurozone average debt-to-GDP ratio as of late 2011 exceeded 87 percent; it had been 66 percent in 2007.[27]

The news that the 2009 fiscal deficit in Greece would be much larger than previously projected actually did not lead to a measurable loss of investor confidence in Greece's ability to refinance its debt and access new funds to cover ongoing deficits. Yields on Greek two-year and five-year benchmark government bonds were slightly lower in the five working days after, than in the five days prior, to the October 20 announcement by George Papaconstantinou, then finance minister in the new Socialist government, that the budget deficit would be far higher than estimates provided by the former Conservative administration.[28]

The erosion of investor confidence that would take place later on could have been prevented if Greece's eurozone partners had seized the initiative and worked constructively with the new government in Athens to come up with a preemptive plan to introduce fiscal austerity and implement structural reforms that was backed by Europe and the IMF. After all, the public debt of Greece was minuscule by eurozone standards: it represented as of end-2009 a mere 3.4 percent of eurozone GDP, or 4.2 percent of total eurozone government debt. Early on, Greece could have been stabilized—and for a fraction of what it has cost so far.

Instead, initial hesitation in Athens on the part of Prime Minister George Papandreou, combined with inertia and indecision that gripped the eurozone in assembling a stabilization program for Greece until six months later, would plant the seed of doubt among the credit-rating agencies, market analysts, and investors—and not just about Greece's fate, but also about the vulnerabilities of other countries sharing the single European currency. This is why a few months after Greece was provided with official funding, Portugal and Ireland also had to be supported by the EU and the IMF.[29] In essence, Greece unwittingly played the role of the child in Hans Christian Anderson's famous tale, pointing out that the eurozone "Emperor" was stark naked.[30]

The erosion of investor confidence in Greece started in December 2009, when all three of the leading rating agencies downgraded the sovereign (Fitch and Standard & Poor's from A- to BBB+ and Moody's from A1 to A2, all with a negative outlook). That fanned concerns that Greek government bonds would be excluded from ECB (European Central Bank) market operations when collateral credit-quality rules returned to pre-crisis levels at the end of 2010—concerns that were aggravated in mid-January when President Jean-Claude Trichet said that the bank would not change its collateral policy for the sake of "any particular country."[31] (In the event, the ECB would announce in late March that it was extending its emergency collateral rules into 2011, and in May it dropped all restrictions on Greek bonds to ensure they did not become ineligible after the country was downgraded to "junk" level by Standard & Poor's.) Yields on two-year Greek government bonds rose from below 2 percent in

[27] Eurostat, *Newsrelease 20/2012*, February 6, 2012.

[28] Greek bond yield data courtesy of Bloomberg. "The news was delivered at a meeting of European Union finance ministers, was unpleasant but not unexpected for Greece's 15 eurozone partners. They had suspected that the financial crisis would have a more serious impact on Greece's deficit and debt than had been admitted in Athens." See Tony Barber, "Greeks Aim to Cut Deficit," *Financial Times*, October 21, 2009.

[29] Domenico Lombardi, "The Euro-Area Crisis: Weighing Policy Options and the Scope for U.S. Leverage," *U.S. Senate Subcommittee on Security and International Trade and Finance Hearing*, September 22, 2011, p. 2.

[30] This is a reference to serious flaws in the eurozone's governance structure that have become obvious during the past few years as a result of the handling of the European banking and sovereign crises—and not only to the hesitant leadership of German chancellor Angela Merkel. For an incisive analysis, see Matthias Matthijs and Mark Blyth, "Why Only Germany Can Fix the Euro," *Foreign Affairs Snapshots*, November 17, 2011.

[31] European Central Bank Press Conference, January 14, 2010.

early December 2009 to a peak of 6.5 percent in early February 2010, before subsiding to around 5.5 percent later that month.

Investor confidence was undermined again in April 2010 ahead of an agreement between Greece and the IMF, ECB, and European Commission (the so-called Troika) on an economic stabilization and reform plan backed by a joint European Union-IMF financing package worth €110 billion. Yields on two-year Greek government bonds increased from 4.5 percent in late March to above 18 percent in early May before dropping below 7 percent by mid-May, on the heels of both the financing package and news that the ECB would buy government and private debt in the biggest attempt yet to end the European financial crisis. The European Financial Stability Facility (EFSF) was born, the region's "temporary" bailout mechanism, with an initial capital of €440 billion.

Another investor scare took place in mid-June 2010, when Moody's concurred with Standard & Poor's move in late April and downgraded Greece's government bond ratings to "junk" (to Ba1 from A3), a level "which incorporates a greater, albeit, low risk of default."[32] Yields on two-year Greek government bonds rose from 7.5 percent to 10 percent prior to easing down to 9.5 percent in early July. There followed an additional, temporary loss of investor nerve in mid-August, but then the bond market calmed down partly owing to praise from the IMF for Greece's continuing effort to rein in its fiscal deficit. Yields on the two-year bonds fell to as low as 7.25 percent by mid-October.

The Greek Tragedy, Act II

What turned out to be the destruction of investor confidence on a permanent basis began on October 18, 2010, when German chancellor Merkel and French president Sarkozy met in Deauville (France) and agreed that private investors must "contribute" to future European sovereign bailouts. This would be the price of a deal to set up a larger, permanent bailout fund to replace the EFSF, because according to Merkel the current system of state-funded rescues had allowed for too much "moral hazard" to creep into the bond market.

The financial markets were understandably roiled. In Greece, two-year bond yields jumped from 7.25 percent back up above 10 percent. On November 4, the ECB's Trichet expressed public concern that forcing bondholders to take losses would drive up borrowing costs. On November 12, seeking to calm the financial markets, the finance ministers of Europe's five largest countries issued a statement clarifying that any private-sector involvement (PSI) would not apply to any outstanding debt, and would only come into effect from 2013. However, irreparable damage to confidence was done.

The following March (2011), Moody's became the first of the major rating agencies to slash Greece down to single-B status, citing in part "the lack of certainty surrounding the precise nature and conditions of support that will be available to Greece after 2013, and its implications for bondholders."[33] It was followed by Standard & Poor's and Fitch two months later, after the top European finance ministers gathered in Luxembourg (in May) to discuss further aid for Greece—but on condition that it would be accompanied by sacrifices made by private creditors. The ECB's Trichet walked out, refusing to participate in any meeting that discussed such "haircuts."[34]

Later that May, European finance ministers for the first time floated the idea of talks with bondholders to extend Greece's debt-repayment schedule. Two weeks later, Moody's downgraded Greece to Caa1, consistent with a 50 percent probability of default, in part because of the likelihood that the Troika would "make the provision of financial assistance to Greece over the medium term conditional on a debt restructuring, in which private-sector creditors would absorb some economic losses."[35]

In early June, Berlin proposed extending the maturities on Greek bonds by seven years. Within days, Standard & Poor's responded by downgrading Greece to CCC, citing that "the risk of default . . . within the next 12 months has increased significantly," and that in the event of a default, bondholders would recover only 30–50 percent of what they were owed.[36] For his part, Mario Draghi, the incoming president of the ECB, warned during his confirmation hearings against forcing private investors to take part: "All in all, the costs outweigh the benefits," he said.[37]

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[32] Moody's Investors Service, "Moody's Downgrades Greece to Ba1 from A3, Stable Outlook," June 14, 2010.

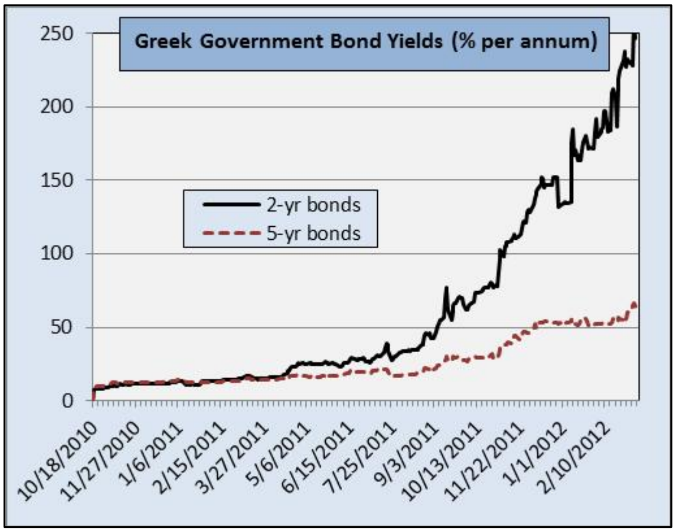
[33] Moody's Investors Service, "Moody's Downgrades Greece to B1 from Ba1, Negative Outlook," March 7, 2011.

[34] Asked about the likelihood of a potential Greek default, Trichet said, "It is not in the cards." Stephen Castle and Landon Thomas Jr., "Ministers Meet to Study Fixes on Greek Debt," *New York Times*, May 6, 2011.

[35] Moody's Investors Service, "Moody's Downgrades Greece to Caa1 from B1, Negative Outlook," June 1, 2011.

[36] Standard & Poor's, "Long-Term Sovereign Rating on Greece Cut to 'CCC'; Outlook Negative," June 13, 2011.

[37] Stephen Castle, "Mario Draghi Holds E.C.B. Line against Restructuring for Greece," *New York Times*, June 14, 2011.



As the IMF would admit in a July 2011 report, the very public, protracted debate in Europe over this issue would take a heavy toll in Greece, not only by propelling bond yields ever higher, but by encouraging a flight of bank deposits and also, via rating downgrades, to a decrease of value on Greek collateral with the ECB, necessitating banks to post additional collateral when they could least afford it. Bank stress, in turn, was encouraging a major credit contraction and aggravating the country's deepening recession.[38]

Negotiations between Troika officials and some 40 mainly European banks represented by the Institute of International Finance (IIF) finally reached agreement on a bond exchange that would deliver financing to Greece of €54 billion from mid-2011 to mid-2014, and a total of €135 billion from mid-2011 to end-2020. It was a Brady Plan vintage 2011, involving the voluntary exchange of outstanding Greek bonds for par and discount bonds entailing an extension of maturities and either reduced coupons or principal forgiveness. Bonds maturing in 2030 would be fully collateralized and one maturing in 2015 would be partially collateralized. All instruments were to be priced to impose an NPV loss of 21 percent.[39] Needless to say, the rating agencies responded promptly by cutting their assessments yet again (Moody's to Ca, S&P to CC, and Fitch to CCC).

The Greek Tragedy, Act III

The ink was barely dry on this debt restructuring deal when its adequacy began to be questioned. The gloom about the future of the eurozone that became pervasive starting in August 2011 caused many officials to revise their economic forecasts (including for Greece) in a direction that suggested the debt relief on offer would be insufficient, the cost of purchasing collateral to back the new bonds would be too high, and the voluntary participation rate of creditors would prove insufficient.[40] This led to a hardening of official attitudes and to an October demand that private creditors agree to a new plan entailing the forgiveness of at least half of what they were owed, with lowered coupons and no collateral backing. One of the (circular) arguments put forth was that since the prices of Greek bonds had plunged to about 36 percent of face value from 75 percent since the deal had been forged in July, the terms of the original deal were now too generous to bondholders.[41]

There followed several months of negotiations between the Troika, Greece, and creditor representatives, but most of the time was taken up by various Troika-Greece economic and political issues. A confrontation between European leaders and Greek prime minister Papandreou over his desire to submit the latest austerity and financing plan to a national referendum elicited an ultimatum from EU leaders (on November 2). Papandreou decided to step aside and give way to a new unity government headed by Lucas Papademos, a former ECB vice president.

The negotiations with the creditors resumed in February (2012) and a new debt-relief plan was finally agreed on February 21, reportedly prompted by the impression conveyed to creditor representatives that the eurozone leadership might countenance a unilateral default on Greece's part.[42] Under the terms of the deal, investors were "asked" to forgive 53.5 percent of what they were owed, and to exchange 31.5 percent of their remaining principal for new, low-coupon Greek bonds with maturities of 11 to 30 years, and the rest (15 percent) into two-year notes issued by the European Financial Stability Facility.[43]

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[38] IMF, "Greece: Fourth Review under the Stand-By Arrangement," July 4, 2011.
[39] IIF, "IIF Financing Offer," July 21, 2011.

[40] It was originally estimated that Greece would have to borrow €35 billion from eurozone member states to buy the AAA bonds needed to back the new securities to be created for the debt swap, but the intervening global rally in high-quality debt had made the intended bonds pricier, such that Greece would now need to borrow an extra €12 billion. See Landon Thomas Jr., "European Banks Face Huge Losses from Greek Bonds," *New York Times*, October 4, 2011.
[41] Ibid.
[42] "The Greek bailout appeared to hang in the balance when rumors circulated that Germany's finance minister, Wolfgang Schäuble, was willing to contemplate a Greek default." See Stephen Castle, "Europe Agrees on New Bailout to Help Greece Avoid Default," *New York Times*, February 20, 2012.
[43] Holdings of Greek Treasury bills were excluded. The coupon on the new bonds was set at 2 percent until February 2015, 3 percent

The resulting debt relief is equivalent to about half of Greece's 2011 GDP, and all-in NPV losses to investors were estimated to be between 70 and 75 percent, depending on the discount rate applied (9–12 percent). The restructuring proposal was part and parcel of a €130 billion loan program that Europe and the IMF agreed to in return for a new round of Greek austerity and reform measures. Acceptances were requested by the close of business on March 8, and a participation rate of at least 95 percent was achieved.

The debt restructuring was billed as a "voluntary transaction" involving private-sector holders of approximately €206 billion (face amount) of Greek government bonds.[44] However, it was not to be really voluntary in various respects. First, most of the bonds were held by Greek banks, or else by dozens of European banks and insurers, all of whom operate under the thumb of their respective government regulators—and most of whom have become dependent for funding on the ECB. Realistically, they had no choice but to participate.

Second, the Greek parliament hastily passed a law retroactively introducing "collective action clauses" (CACs) into the €177 billion of targeted bonds governed by Greek law, specifying that by tendering into the exchange, every bondholder was automatically voting to make the terms of the exchange applicable to all other bonds.[45] Therefore, once consents from €152 billion of bonds representing almost 86 percent of holders were received, the terms of the remaining €25 billion were amended as if they too had consented. The introduction of CACs in sovereign bonds is no novelty, but to our knowledge it has never been done retroactively—a clear violation of the "sanctity" of contracts. It is no wonder that the new bonds arising from the debt exchange are subject to English law; otherwise, their indentures would have no credibility.

Third, the Greek authorities made it plain that nonparticipants into the exchange should not expect any payments. At a March 5 meeting with investors in Frankfurt, the head of Greece's Public Debt Management Agency stated that the country's economic program "does not contemplate the availability of funds to make payments to private sector creditors that decline to participate."[46]

The message was presumably intended to investors in the €29 billion of bonds issued under foreign law or by state-owned enterprises under government guarantees, whose terms could not be amended unilaterally. As of the due date, €20 billion (69 percent) of these bonds were tendered into the exchange, and some of the rest may yet be turned in, since many of them already included CACs and the authorities have since extended the deadline to April 4. As to any eventual holdouts, litigation in the case of Argentina has demonstrated that it is very difficult to collect from a sovereign that is unwilling to pay—although one would hope that Greece would behave more honorably if it came to that.[47]

It is noteworthy that the €206 billion in government bonds subject to debt forgiveness and restructuring account for less than 60 percent of the Greek public debt, which totaled €356 billion as of end-2011. Treasury bills, which the authorities excluded in order not to taint this short-term segment of the market, represented a mere €15 billion of that. Loans from the European Union and the IMF accounted for €74 billion, and it is understandable that these creditors, who are providing new funding, would likewise have been excluded. That left some €61 billion that was potentially up for grabs.[48]

Most of that figure, however, involved European Central Bank holdings of Greek government bonds purchased through the Securities Market Program (SMP), the ECB's window to support the secondary market for eurozone sovereign bonds. The working assumption among many observers had been that the ECB, or possibly individual national central banks, would have found a way to contribute to Greece's debt-relief exercise by exchanging their existing bonds for new ones paying, for instance, lower interest rates.

As it turned out, in mid-February the ECB did swap its stock of Greek government bonds for new ones—but on identical terms, just with a separate ISIN (International

for the following five years, and 4.3 percent until 2042. See IIF, "Press Release: Greek Debt Exchange," February 28, 2012. Creditors were also offered GDP-linked bonds that will pay interest if the economy grows by more than 2 percent per annum during 2020–2041, and faster than 2.25–2.90 percent before that (depending on the specific year).

[44] Hellenic Republic Ministry of Finance, "PSI Launch Press Release," February 21, 2012.

[45] Under the Greek Bondholder Act (Law 4050/2012), if holders of at least 50 percent of outstanding Greek law bond vote and two-thirds of them are in favor of a proposed amendment—in this case, the debt exchange offer—it becomes binding on all bondholders.

[46] Hellenic Republic Ministry of Finance, "Public Debt Management Agency Press Release," March 6, 2012.

[47] It is conceivable that Greece could be held accountable under one or more of the many potentially applicable conventions and treaties, including bilateral investment treaties, of which it is a signatory.

[48] Data from Hellenic Republic Ministry of Finance, "Public Debt Bulletin," December 2011; and from IMF, "Greece: Request for Extended Arrangement under the Extended Fund Facility," March 9, 2012.

Securities Identification Number) from that of other Greek government bonds. The swap did not include bonds held by individual eurozone central banks. What eurozone finance ministers have since agreed is that future profits made by the ECB from Greek government bonds will be distributed alongside other profits to eurozone governments, and that they in turn "may be allocated by Member States to further improving the sustainability of Greece's public debt."[49]

As Standard & Poor's has pointed out, however, since the ECB's newly minted Greek government bonds were exempted from the retroactively applied CACs and were thus protected from any forced write-downs, the practical effect is that all other bondholders are now effectively subordinated to the ECB in terms of payment. "The ECB's swap has established a new precedent by adding another class of superior creditor to the existing group comprised of the ESM [the upcoming European Stability Mechanism], the IMF, and other multilateral development banks. We believe that this development could further weaken the prospects of peripheral eurozone sovereigns currently receiving official funding to regain the ability to access the capital markets and could raise borrowing rates of those sovereigns still accessing the primary markets."[50]

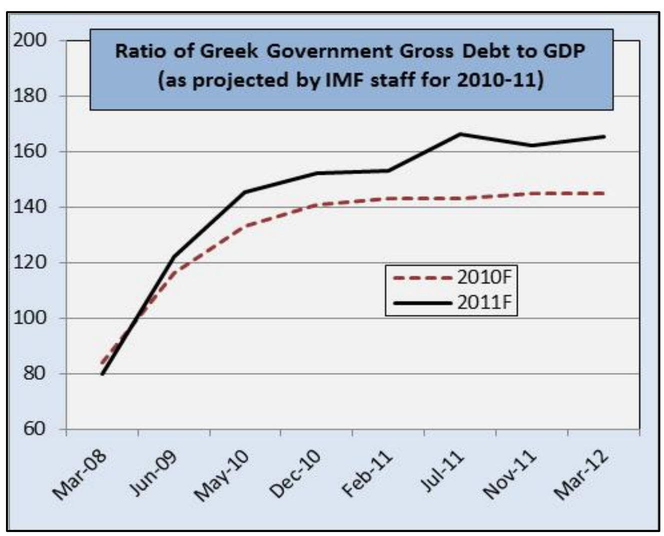
Finally, it should be noted that the extent of debt relief required of private creditors was a function of at least two judgment calls that can certainly be questioned. The first was the decision to recapitalize the Greek banking system with EU and IMF funds—and to do so very generously. This decision increased the size of the official-sector loan package by €50 billion, and thus the extent of losses imposed on private creditors—to minimize the burden on the government of servicing all the new official debt it is taking on. The irony is that a less punishing restructuring would have reduced the hit taken by Greek banks, and thus the recapitalization bill.

As the IMF staff report freely admits, "a typical recapitalization program would see viable banks recapitalized using [Greek] government bonds (with perhaps some regulatory forbearance on capital ratios while problems are worked out) and the unwinding of unviable banks." In the case of Greece, there was a political decision to depart from the customary "owing to the need to secure liquidity support from the Eurosystem, and to reassure regulators of Greek bank subsidiaries in neighboring jurisdictions."[51]

Moreover, it was decided that all bank deposits would be protected and so would all the senior unsecured creditors of Greek banks. This is a very expensive way to nurse an insolvent banking system back to health, and it has yielded a stunning result: those who bought bonds issued by Greek banks are faring much better than those who bought sovereign bonds—the inverse of the usual outcome.

The second judgment that is highly questionable is the decision to extract huge concessions from private creditors so that Greece's debt burden will be at a sustainable level (deemed to be 120 percent of GDP) by 2020. The fact is that ratios of debt to GDP are not reliable predictors of creditworthiness. Moreover, it is easy to make outsized mistakes when trying to forecast a ratio of debt to GDP during exceptional circumstances, and the IMF staff is notorious for its errors in forecasting such ratios and thus its failures to predict debt sustainability—or unsustainability.[52]

Recent experience is instructive: in May 2010, the IMF staff projected that Greece's public debt would reach €325 billion by the end of 2011—a year-and-a-half later—and that it would represent 145 percent of 2011 GDP. The staff's latest estimate (as of March 2012) is that the stock of debt last year reached €329 billion (a very minor deviation from forecast) but that it represented 165 percent of 2011 GDP—a whopping difference. And the reason is a major underestimation of the contraction in GDP that has taken place in so short a time, such that while the IMF's forecast for the numerator proved quite accurate, that for the denominator was off considerably.[53]



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[49] Eurogroup, "Eurogroup Statement," February 21, 2012.
[50] Standard & Poor's, "ECB Greek Bond Swap Results in Effective Subordination of Private Investors," February 24, 2012.
[51] IMF, "Greece: Request for Extended Arrangement," pp. 27–29.
[52] Charles Wyplosz, "Debt Sustainability Assessment: Mission Impossible," *Review of Economics and Institutions*, Fall 2010.
[53] IMF, "Greece: Request for Extended Arrangement," and prior IMF staff reports from the dates noted in the chart and the text.

Who is to say that Greece's GDP cannot bounce back from its current bottom, and thus that there cannot be an upside surprise a few years from now?

In sum, the case of Greece has set a number of troubling precedents. The country had learned to live—and had been allowed to live by its eurozone partners—with a relatively high level of public debt. Successive governments were able to count on a stable, predictable demand for their bonds, at least until investor confidence started to erode in late 2009 and early 2010. Greece was finally helped by its eurozone partners and the IMF in May 2010 and was on the mend, when all of a sudden the rug was pulled from under it by Chancellor Merkel's insistence (starting October 2010) that private creditors "contribute" to future bailouts.

As the months passed, the intra-European rhetoric escalated, rating-agency downgrades multiplied, and the specter of default started to loom ever larger. Consequently, the demand for Greek government bonds evaporated, the banking system went on to lose one-third of its deposits, and the economy spiraled into the greatest depression in nearly a century. To be sure, Chancellor Merkel's motivations and behavior cannot be compared to those of Ecuador's Correa, but Germany's very public hard line on Greece and its private creditors paved the road for an eventual default, and imposed outsized losses on investors, that could have been avoided or at least minimized.

Expedient solutions were adopted in an ugly demonstration that the ends justify the means. The largest sovereign default and greatest creditor losses in history were validated by forecasts of debt unsustainability that are prone to large error, and arrived at after a questionable decision to protect Greek bank creditors and depositors all too generously.

Along the way, private investors were subordinated to the ECB and its network of national central banks, a precedent that will weigh on investors in other faltering countries. The rewriting of local law in Greece with retroactive effect cannot be compared to the large-scale violation of contracts witnessed in Argentina a decade ago, but is troubling nonetheless. More than 97 percent of the outstanding bonds of Spain, Italy, Portugal, and Belgium are governed by local law,[54] so these countries could also enact legislation similar to Greece's—and pass on the cost of fiscal retrenchment to bondholders, rather than to those who actually benefited from government largesse.

The road to perdition for investors started out in Buenos Aires, wound its way through Quito, and has now reached Athens. Time will tell where it will be extended to next—but chances are that it will be to some other capital in Europe.

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[54] Moody's Investors Service, "Unilateral Action Threatened by Greece Is Also Available to Other Sovereigns," February 6, 2012.