Delaying default only extends pain

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HIGH & LOW FINANCE

NEW YORK A Greek debt restructuring — a polite term for default — is unthinkable, according to the Greek finance minister.

"It would have a tremendous cost, with no benefit," the minister, George Papaconstantinou, said in an interview on Greek television. "Greece would be out of markets for 10, 15 years."

To financial markets, and to many other observers, it is more than thinkable. It is very close to a sure thing. When, how, and how messy it will be are open to question.

It has been almost a year to the day since Europe bailed Greece out, amid much self-congratulatory talk. Olli Rehn, the European commissioner for monetary policy, said the move had been "particularly crucial for countries under speculative attacks in recent weeks," a reference to Spain and Portugal.

Markets — described by Anders Borg, Sweden's finance minister, as "wolf packs" — returned to their lairs on the Monday after the bailout. The yield on three-year Greek government bonds plunged to 7.7 percent from 17.5 percent, as the price of such bonds soared by 28 percent in a single day.

And how have things gone since then? Just fine in Germany, where growth is accelerating, unemployment is lower than at any time since German unification and the European Central Bank is raising interest rates to curb inflation. More or less acceptably in France and Italy, each of which recorded gross domestic product growth of 1.5 percent in 2010, well below Germany's 4 percent.

But not well at all in the country that supposedly was rescued. Greece's economy shrank 6.6 percent, far more than the 1.9 percent decline in 2009.

And those market wolves are howling again. The yield on Greek three-year bonds is more than 23 percent — not that anyone thinks that yield will really be received. The yields on similar Portuguese and Irish bonds have also soared into double digits. Investors are a little more skittish than they had been about Spanish and Italian bonds, but there is no sense of impending disaster.

Longer-term rates on Portuguese debt did slide a little this week after a tentative agreement on a bailout for that country was reached, but they remain at levels that show widespread doubts about the country's ability to pay.

The trading patterns of Greek bonds indicate that traders expect a restructuring, and think it will be a messy one.

That yields are as low as they are — if you can call 23 percent low — is a reflection of the fact that the bailout has been continuing below the surface. The European Central Bank has been lending money to Greek banks, accepting Greek bonds as collateral on loans to other banks, and even buying bonds.

Keeping up the fiction that all will somehow be well if we just wait has its own disadvantages.

"Delays in restructurings are costly," Alessandro Leipold, the chief economist of the Lisbon Council, a research institute in Brussels, and a former official of the International Monetary Fund, wrote in a paper this week. He warned that the longer the inevitable was delayed, the more potential economic production would be lost and the greater the amount of good money would be thrown after bad in the form of ever larger bailouts. Ultimately, he said, the result will be larger losses for bondholders.

"The real problem is capital shortfalls in European banks," said Eli Whitney Debevoise II, a partner at the Arnold & Porter law firm and a former U.S. executive director of the World Bank, who has been involved as a lawyer for countries and creditors in several restructurings. Until the banks have more capital, forcing them to admit to losses would be problematic, to put it mildly.

Stalling has worked before. In the early 1980s, major American banks could not afford to admit that they had lost huge sums in the Latin American debt crisis. "There was," Mr. Debevoise said in an interview, "a five-year period of temporizing while Citibank and other banks rebuilt capital." Finally, there was a debt restructuring and the banks admitted to their losses.

Currently, there are probably some European banks that would be hard-pressed to take losses, a group that may include some of the German landesbanks, which are generally owned by state governments and are badly in need of new capital.

The E.C.B. itself would hate to report losses, which is one reason that the first Greek restructuring, when it comes, may avoid forcing bondholders to accept "haircuts," or reductions in principal. Instead, cutting interest rates and postponing maturities could allow the central bank to pretend it had not lost money. Eventually, however, haircuts seem inevitable.

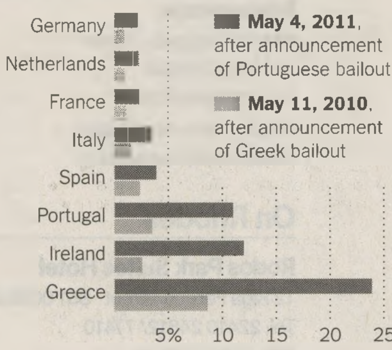
Although there have been plenty of defaults and restructurings by national governments in recent decades — a partial list includes Argentina, Brazil, Uruguay, Russia, Ukraine, Pakistan and Ecuador — there is no agreed-upon way to arrange a restructuring. Nearly a decade ago, the I.M.F. tried to put together what it called a "sovereign debt restructuring mechanism," a sort of international bankruptcy law. The effort collapsed.

As a result, restructurings can be messy. Some bondholders can try to hold out on approving a plan, hoping they will be paid more than those who agree. Lawsuits will be filed.

Sooner or later there will be a Greek default, even if it is officially described as a "voluntary restructuring" approved by most bondholders.

Europe wants to delay that at least until 2013, when new rules are supposed to kick in that would let official creditors — like Europe's bailout fund — do better in a deal than private creditors. But it seems less and less likely that the inevitable can be delayed that long.

YIELDS ON 3-YEAR GOVERNMENT BONDS



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