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Cosmetic surgery will not save the eurozone

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At least European leaders can agree on **Christine Lagarde**, France's finance minister, as the next managing director of the International Monetary Fund. But behind this display of unity, a war is raging over how to solve the **Greek debt crisis** as we enter the most dangerous phase of the crisis yet.

We have known for some time that the European Central Bank is hostile to any form of debt restructuring. This also includes a "voluntary" extension of the maturity of Greek debt. European finance ministers have invented a new word for this: "reprofiling" – a well-known expression taken from the field of cosmetic surgery.

What we did not know before was quite how strongly the ECB feels about this. Jean-Claude Trichet, ECB president, stormed out of a meeting with finance ministers on May 6. This was the famous super-secret meeting whose very existence had been denied by officials. The ECB has since stepped up its rhetoric, and is now threatening to deny Greek banks access to the ECB's refinance operations after any restructuring.

Think about this for a second. Cutting Greece off from ECB liquidity would constitute a dramatic escalation of the **eurozone debt crisis**. It would force Greece out of the eurozone within days. You could say that the ECB is threatening to create so much mayhem in the financial system that the monetary union would effectively collapse.

What to do now? One option would be to call the ECB's bluff – if you think it is a bluff – and order a rescheduling of Greek debt. Then take a step back, and see what happens. Will the ECB really destroy the eurozone? Then again, do we really want to bring about a situation in which the ECB is faced with a straight choice between an irrecoverable reputational disaster, and a irrecoverable factual disaster?

My guess is that the ECB's position will prevail because the ministers are themselves divided. Ms Lagarde agrees with the ECB – or at least, she did last Tuesday. Angela Merkel has also ruled out an involuntary restructuring before 2013. The German chancellor is a cautious advocate of voluntary schemes of investor participation, but has not yet said what she means by that. I think caution will ultimately prevail. There will be no restructuring in the near future.

What I can see, however, is some variant of the Vienna initiative. This was a programme created in 2009 at the behest of the European Bank for Reconstruction and Development to persuade western banks not to withdraw from the central and eastern European markets. They also pledged to recapitalise their subsidiaries in the region.

The Vienna initiative solved a collective action problem and it worked. The situation in Greece, however, is different. The issue here is not to maintain the capital base of EU banks operating in Greece. But one could persuade financial companies to maintain a degree of exposure to Greece as a gesture of support.

This will not, of course, solve the Greek debt crisis. It would take a large haircut, or an extreme rescheduling, to reduce the net present value of Greek debt in any meaningful way. But a Vienna-type initiative might still be a useful political gesture to help conflicted national parliaments, like Germany's Bundestag, pass the next loan package to Greece.

The best actions eurozone governments could take at this stage would be to stop all talking at the same time, to be more careful when discussing restructuring or rescheduling, not to invent new words and to revisit an important aspect of the design of the European financial stability facility (EFSF). They should allow the EFSF to engage in secondary market bond purchases with the explicit remit of aiding a debt restructuring. That would allow the EU to launch an equivalent of a Brady bond. The EFSF could swap its own triple-A rated securities for Greek bonds, at a discount. The counterparty would suffer a loss on the transaction, but would gain a triple-A rated paper in return. That would actually provide a market-based incentive for holders of peripheral debt securities to swap. There would be no need for unofficial threats, moral suasion or anything else that might trigger a debt downgrade. It would cost a bit of money, but not nearly as much as any of those total default or total bail-out options.

What about reprofiling? The argument is that it buys time. But is this not what the European Union and IMF's loans are meant to do? A reprofiling may quite possibly be the worst of all options. It will not render Greek debt sustainable, yet it may trigger a potentially catastrophic credit event. Even if you discount the dire warnings from the ECB, it is still not clear what good it will do. And if you really think that time would solve the problem, would it not be a lot easier simply to give them a new loan? The whole reprofiling discussion is a sign of hypocrisy.

Having Ms Lagarde at the IMF might help the eurozone, but it cannot make up for disastrous and incompetent crisis management. The eurozone has essentially three options: follow the ECB, and roll over existing debt for as long as it takes; change the rules of the EFSF and accept Brady bonds; or force a full debt restructuring, and accept the consequences. It is going to be one, two or three. A nose job will not do.

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