Debt deal for Greece is spurring speculation

LONDON

Hedge funds buying government bonds cheap in hopes of big payday

BY LANDON THOMAS JR.

Greece may never be able to pay off its huge debts, but its bonds, long scorned by investors, are suddenly being gobbled up by opportunistic hedge funds.

After a number of investors struck gold by betting against French banks, many have turned their attention to the hot euro zone trade of the moment: a risky gambit that has investors buying up Greek government bonds that traders say are now changing hands for as little as 36 cents for each euro in face value.

The speculators hope to book a fat profit on the expectation that the European Union and the International Monetary Fund will once again bail out Greece because they fear a global financial disaster if they don't.

Under the deal Greece struck in July with its banks as part of Europe's rescue plan, a substantial portion of its existing bonds are scheduled to be swapped into new longer-term securities that would be valued as high as 79 cents to the euro. If the deal closes in late October — assuming the latest bailout system is ratified by all 17 euro zone parliaments — those who bought the bonds recently at distressed prices could walk away with a quick profit of as much as 100 percent.

But what is good for hedge funds is not necessarily good for Greece.

In fact, the popularity of this trade is just the latest sign that the carefully constructed debt swap agreed to by Greece and its private-sector creditors may be a much sweeter deal for investors than it is for taxpayers.

''Everyone knows this was a good deal for the banks,'' said Otmar Issing, a top German economist who served on the executive board of the European Central Bank. ''It will not help Greece at all.''

According to a person with direct knowledge of the debt swap, about 30 percent of the investors who are expected to participate in the exchange bought their bonds after July 21. They are not the original debt holders — mostly large European banks — but more speculative investors looking to cash in on the steep fall in Greek bond prices.

With the debt swap expected to cover about €135 billion, or $183 billion, in existing bonds, that suggests various hedge funds and other investors have bought as much as €40 billion worth of Greek debt since then.

The behind-the-scenes deal making may be obscure but it helps explain why Chancellor Angela Merkel is having such a hard time persuading key German lawmakers to vote for the Greek bailout on Thursday.

With people like Mr. Issing arguing that banks and other creditors have not

GREECE, PAGE 18

EUROPE'S RESCUE FUND ADVANCES

Finland voted to support a euro zone bailout despite a dispute over its demand for collateral from Greece. *PAGE 16*

29/9/2011 118

Greek debt deal spurs bond speculation

GREECE, FROM PAGE 1

been forced to contribute a larger share of Europe's ever rising bailout bill, it's no surprise that politicians are worried about a public backlash against the bailout. Mr. Issing contends that the owners of Greece's paper should be required to take roughly a 50 percent write-down on their holdings as part of an "orderly" default that would reduce Greece's overall debt burden by enough to allow it to meet its obligations without further borrowing.

Speaking at a conference in Berlin on Tuesday that discussed the future of the euro zone, Mr. Issing shook his head in frustration, pointing out that in light of the recent collapse in Greek bond prices, some banks might even be able to book a loss that is significantly less than the advertised 21 percent.

While not a member of the government, Mr. Issing is in many ways the leading voice of Germany's economic establishment.

But supporters of the Greek bailout say it is too late to change the terms and that any effort to alter the equation between Athens and its creditors could scuttle the whole carefully-constructed deal. They also argue that many European banks holding Greek debt, particularly those based in Greece itself, are too thinly capitalized and underfunded to absorb any larger losses at the present time.

Analysts say that further debt write-offs are likely to be delayed well into next year, after Europe has put in place a new financing system that could bolster the region's banks.

"You need to equip yourself with sufficient fire power — then you can talk about restructuring," said Jean Pisani-Ferry, the director of Bruegel, a nonprofit economic research organization in Brussels.

That the deal is a good one for banks should not come as a surprise.

Greece had little input in the setting of the transaction terms, which were put together on the fly by representatives from the Institute of International Finance, a trade group for global bankers in which Josef Ackermann, the departing chief executive of Deutsche Bank, is chairman.

Defenders of the swap say that while it may not be ideal, it was the best deal that could be reached at the time. If hedge funds make some money along the way, they say, that is a small price to pay for securing a contribution from the private sector, modest as it may be.

Now that analysts are actually crunching the numbers on the debt swap, that contribution is looking even more modest than originally advertised. Some estimate that most participating banks will experience losses closer to 10 percent or even less on bonds that the private market values at less than 40 percent of their original value, or a loss of more than 60 percent.

"It is a relatively attractive deal for the private sector," said Cagdas Aksu, a credit analyst at Barclays Capital who has published a number of research notes on the exchange.

ALKIS KONSTANTINIDIS/EUROPEAN PRESSPHOTO AGENCY

A protest by retirees Wednesday in Athens. A government debt swap aimed at rescuing Greece may turn out to be a much sweeter deal for investors than it is for taxpayers.

That was well known among policy makers. Less understood, though, is how hedge funds stand to make out if the deal is completed and they swap the bonds they bought at 40 cents and below for bonds that, depending on several variables, could be worth 60 cents to 80 cents.

Those speculating in Greek bonds are taking on certain risks, including the possibility that the country will fail to reach a final agreement with the I.M.F. and the European Union and does not get the next portion of money needed to avoid default. But expectations are growing that Greece has done enough to secure the €8 billion it needs next month and that the bailout system to back up a longer time rescue plan will win approval by the end of October as well.

In that case, not only officials from Washington, Brussels and Athens will be celebrating their success in staving off a Greek bankruptcy. So will a lot of wealthy hedge fund investors.

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Expanded euro zone rescue fund advances

FRANKFURT

Finland votes support, while a top E.U. official presses for greater unity

BY JACK EWING AND STEPHEN CASTLE

Europe took another step Wednesday in its slog toward approval of a broader bailout fund for overly indebted countries, as Finland's Parliament agreed to contribute its share despite an unresolved dispute over its demand for collateral from Greece.

The 103-to-66 vote, with 30 legislators absent, still leaves 7 of the 17 members of the euro zone yet to ratify a bailout fund that, despite expanded resources and power, is considered much too small to fend off further market attacks on Greece and other wounded countries.

The laborious approval process, which can be held up by objections from any one of the countries in the euro zone, has highlighted deep flaws in alliance's decision making. Every major initiative must traverse an obstacle course, and each hurdle can jostle financial markets anew.

On Wednesday, major stock market indexes in Europe fell after three consecutive sessions of gains.

Though Finland can now be checked off the list, the next holdout may prove to be Slovakia, where there was talk a vote on the bailout fund might be delayed until late October, past the unofficial deadline of midmonth. Many Slovakians resent having to help bail out Greece, which, despite its problems, is wealthier.

José Manuel Barroso, president of the European Commission, warned Wednesday that countries in the euro zone must move toward greater unity for the alliance to survive.

"We are today faced with the greatest challenge our union has known in all its history," Mr. Barroso said in his annual State of the Union address at the European Parliament in Strasbourg. "If we don't move forward with more integration, we will suffer more fragmentation. This will be a baptism of fire for a whole generation."

Leaders in Germany and elsewhere played down speculation that they were working on bolder responses to the crisis, like a mechanism that would multiply the borrowing power of the bailout fund, the European Financial Stability Facility. Officials said they were preoccupied with getting parliamentary approval for existing measures.

But the euro zone countries face intense pressure from the United States, China and other countries to more forcefully address the sovereign debt problem before the meeting of the Group of 20 leading economies that begins Nov. 3 in Cannes.

"The euro area has been given an ultimatum to put its crisis once and for all behind its back over the coming six weeks," Jacques Cailloux, chief European economist at Royal Bank of Scotland, wrote in a note to clients.

In an initial attempt to impose more spending discipline on euro zone members and to prevent future crises, members of the European Parliament voted Wednesday in favor of rules that would impose fines on countries that break budget and deficit rules.

Members of the euro zone are supposed to hold their budget deficits below 3 percent of gross domestic product, and total debt below 60 percent of G.D.P., but few do.

Under the new rules, countries that exceed those limits will be pressed to make a cash deposit — in an account that pays no interest — equal to 0.2 percent of G.D.P. If they still fail to rein in spending, they will forfeit the deposit.

While finance ministers would still need to agree to punish countries, the voting system has been adjusted to make it significantly more difficult to block sanctions.

In addition, national budget plans will come under greater scrutiny, and there will be an alert system to try and detect looming problems like the housing bubbles that helped create the debt crises in Spain and Ireland.

The German Parliament is scheduled to vote Thursday on the bailout fund, in what is seen as a crucial test for Chancellor Angela Merkel.

Austria is scheduled to vote Friday. The remaining countries are Cyprus, Estonia, Malta, the Netherlands and Slovakia.

There were indications that Slovakia's Parliament might not vote until Oct. 25, beyond the midmonth deadline set by Olli Rehn, the European commissioner for economic and monetary affairs.

That would be about three months after representatives of the 17 countries in the euro zone agreed to give the rescue fund more money and power. The expanded fund will be able to loan up to €440 billion, or about $600 billion, and issue guarantees for €780 billion.

Mr. Cailloux said that the fund needed about €2 trillion to be effective.

The speaker of the Slovak Parliament, Richard Sulik, said a vote probably would be held Oct. 25, according to Beata Skyvova, a spokeswoman for the Parliament. But one party in the governing coalition was pressing for an earlier vote and more negotiations will take place before a final date is decided, Ms. Skyvova said.

Finland continues to demand that it receive collateral from Greece in return for aid to that country. But Finnish leaders argued that approval for the rescue fund, which will also provide aid to Ireland, Portugal and other countries, was a separate issue.

That reasoning cleared the way for the Finnish Parliament to approve the bill Wednesday.

Finland is still negotiating with its European partners on the collateral issue, and officials in Helsinki have expressed optimism that a solution will be found to address Finnish sensibilities without undermining the aid package.

Meanwhile, Greece moved closer to receiving the next installment of aid it needs to avoid bankruptcy.

Officials from the International Monetary Fund, the European Commission and the European Central Bank were traveling to Athens to assess whether to recommend release of the aid, said Amadeu Altafaj Tardio, a European Commission spokesman.

A decision is likely before a summit meeting of European Union leaders Oct 17-18, according to one European officia not authorized to speak publicly.

During his speech to the Europea Parliament, Mr. Barroso said th changes needed to secure the euro's fu ture might require reopening the Un ion's governing treaty. He reiterat that Greece would stay in the eu zone.

Mr. Barroso confirmed that the Eu pean Commission, the E.U.'s execut branch, would speed up a feasib study on issuing euro bonds — com debt that would be guaranteed by members of the euro zone. He gave clearest support to the idea yet.

"Once the euro area is fully equip with the instruments necessary to sure both integration and disciplin issuance of joint debt will be seen natural and advantageous step fo he said.

"We need to complete our mo union with an economic union Barroso argued. "It is an illu think we could have a single c and a single market with nati nomic approaches."

Mr. Barroso also announced al for a Europe-wide tax on transactions, a move that Ge France support strongly but tries as Britain, the Nethe Sweden say they would bac was agreed to at a global le unlikely, given oppositio United States.

Stephen Castle reported fro Niki Kitsantonis contribute from Athens.

VINCENT KESSLER/REUTERS

José Manuel Barroso, president of the European Commission, at the European Parliament on Wednesday in Strasbourg. "If we don't move forward with more integration, we will suffer more fragmentation," he warned. "This will be a baptism of fire for a whole generation."

JUSSI NUKARI/LEHTIKUVA, VIA REUTERS

Prime Minister Jyrki Katainen of Finland, left, in Parliament in Helsinki. Finland is still negotiating over Greece providing collateral.