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Next time, Greece may have to work much harder

LONDON

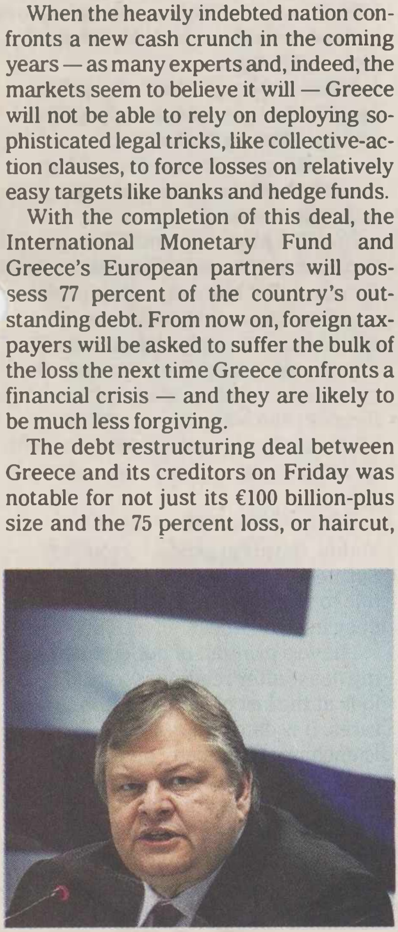
BY LANDON THOMAS JR.

Greece may have been able, and even willing, to use strong-arm tactics to persuade private-sector bondholders to join the debt deal it completed Friday to stave off default. But next time those moves might not work so well.

When the heavily indebted nation confronts a new cash crunch in the coming years — as many experts and, indeed, the markets seem to believe it will — Greece will not be able to rely on deploying sophisticated legal tricks, like collective-action clauses, to force losses on relatively easy targets like banks and hedge funds.

With the completion of this deal, the International Monetary Fund and Greece's European partners will possess 77 percent of the country's outstanding debt. From now on, foreign taxpayers will be asked to suffer the bulk of the loss the next time Greece confronts a financial crisis — and they are likely to be much less forgiving.

The debt restructuring deal between Greece and its creditors on Friday was notable for not just its €100 billion-plus size and the 75 percent loss, or haircut,



ALKIS KONSTANTINIDIS/EPA

Evangelos Venizelos, the Greek finance minister, speaking in Athens on Friday.

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BY ANDREW
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REUTERS

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imposed upon investors. It also underscored Greece's rapid evolution from private-sector debtor to being mostly reliant on the public sector.

In 2008, all of Greece's debt was held by private-sector bondholders. Before the deal concluded Friday, 62 percent of its debt was held by the private sector. Now the figure is 27 percent.

In every way, Greece has become a financial ward of Europe. And, as it is likely that the I.M.F. will be more reluctant to put in new money in the coming years, it will increasingly become Europe, led by Germany, that will have to finance Greece — both directly, through country-to-country loans, and indirectly, through the European Financial Stability Facility, the euro zone's rescue fund, to which most members of the currency union contribute.

As a rule, the I.M.F. does not accept haircuts and insists that its loans are always senior to all other obligations. European politicians, already under pressure from voters for their countries' increasing financial exposure to Greece, will have a difficult time explaining why European obligations must be written down because Greece cannot balance its books.

And while there will be scope in a future Greek restructuring to impose losses on whatever private-sector bondholders remain, any significant debt reduction would have to include the official sector: the European Central Bank, the E.F.S.F., other European countries that made bilateral loans, and the I.M.F.

"It will happen," said Stephane Deo, an economist at UBS in London, referring to the next Greek crisis.

Mr. Deo expects Greece to make a move in 2013, when he said the country would be able to show a primary surplus — meaning that its budget would be in balance if it did not have to pay interest on its debt. Then, Greece would in a better position to ask to stop paying interest and use its money for domestic purposes instead.

"The market is already pricing in" a second round of restructuring, Mr. Deo added, citing as evidence that the new Greek bonds issued in the deal completed Friday were trading at a discount to their par value. That, he said, reflects the view of many investors that there will be other haircuts to come.

The debt deal concluded Friday, the largest in history, will provide immediate relief to Greece, cutting back on €15 billion, or $19.7 billion, in interest and principal it was paying each year to its bondholders. And with the establishment in Greece of a system whereby tax revenue must be used first to pay off debt obligations before being spent domestically, it will no longer be easy for spendthrift Greek politicians to run budget deficits for political purposes.

But even after erasing €135 billion worth of debt from its books, Greece will still be saddled with a ratio of debt to gross domestic product of 151 percent in 2012 and 149 percent in 2013. These debt levels remain the highest in Europe and trail only Japan among developed nations.

And with the Greek economy still in a

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Merkel and Lagarde, a special tie

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Ms. Lagarde, nicknamed l'Américaine back in her native France, has been vocal in support of pro-growth policies on the part of the richer European countries to help their more-indebted neighbors. She has also pressed Europe to make its firewalls — the pools of money available to keep borrowing rates at sustainable levels for all euro zone economies, plus any innocent bystanders to the crisis — so enormous that they scare off any would-be speculators.

Since becoming the head of the I.M.F. — and in stark contrast to her public statements in her previous job, as French finance minister — she has repeatedly castigated Europe for doing too little, being too late, and lacking focus on reviving growth in battered southern European economies.

Ms. Merkel is known for advancing an almost moralistic approach in which overspending by governments represents the greatest evil and the path to stability runs through austerity. And large firewalls, in this view, only give countries like Greece, Portugal and Spain a false sense of security, and an excuse to ease up on the painful measures demanded of them. Ms. Merkel has demanded assurances that all European countries bring their finances under strict control before the governments of the E.U. agree to free up resources to help.

Their differences were brought into sharp relief on a bitterly cold January day when Ms. Lagarde gave a speech at the German Council on Foreign Relations here in Berlin in which she demanded that Germany step up its efforts to save the world from "a 1930s moment."

Switching from her fluent English to halting, phonetic German, she concluded with a line by Goethe. "It is not enough to know, we must apply," Ms. Lagarde told the audience. "It is not enough to will, we must do."

The speech made headlines around the world, evidence of a backroom dispute breaking out into the open. Yet Ms. Lagarde had arrived in Berlin on the eve of her address with a copy of the speech for Ms. Merkel to read before she delivered it in front of the political and foreign-policy establishment. The two women debated the crisis over a long dinner of veal tenderloin in the modern chancellery's 8th-floor dining room.

Ms. Lagarde also brought Ms. Merkel an orange-blossom scented candle from the chic Paris perfumer Fragonard. The candle represented "hope," Ms. Lagarde said. "Because we had tough discussions," she added, there "was an element of symbolism about it."

Though barely a year apart in age, Ms. Lagarde, 56, and Ms. Merkel, 57, appear to be opposites: the glamorous, Chanel-clad French extrovert and the grounded German introvert, who was even recently spotted doing her own grocery shopping in the same suit jacket she had worn to sign the European fiscal pact in Brussels earlier that day.

As a former French finance minister who was once party to the internal efforts to save the euro, Ms. Lagarde has more credibility in policy discussions than her American counterparts. German officials are skeptical of advice from Washington on stimulus and bailouts, saying that it is intended only to aid President Barack Obama's re-election and not solve Europe's long-term structural problems.

"I've been in government and know what securing parliamentary support means," Ms. Lagarde said. "And equally she appreciates that I speak from a position where I have to think about not only Germany but also the whole of Europe and the stability of the international scene."

In a sense Ms. Lagarde's better relationship with Ms. Merkel makes it possible to bridge a wider gap between the Americans and the Germans, giving her the chance to potentially serve as a successful mediator. A French official who worked with Ms. Lagarde said that she was "one of those policy makers that Ms. Merkel would listen to. There is a relationship of trust, even if there may be issues on which their views differ."

And indeed, people close to the negotiations say that German leaders have given tacit promises that the Europeans will raise more money for their firewall, given enough time to build a consensus on the Continent. Officials also say the I.M.F. should have little trouble raising the $500 billion in lending capacity once that happens.

"There is a relationship of trust, even if there may be issues on which their views differ."

Analysts have noted that the austerity Ms. Merkel has been pressing on other European countries has long been the I.M.F. prescription, while the tough talk from Ms. Lagarde could help Ms. Merkel sell unpopular measures as necessities at home.

"I have a suspicion that the two ladies are not as far apart as it appears, or is made to appear, in public," said Stephan Richter, president of the Globalist Research Center in Washington.

In the years it has taken to find a consensus on how to handle the crisis, critics say the toll to business confidence, financial markets and economic growth have been unnecessarily high. Now the hope for a long-term solution to Europe's debt crisis could well rest on the ability of these friends to bridge the divides before Europe's chronic problems flare up again.

Though Europeans of the same generation, Ms. Merkel and Ms. Lagarde once had lives as divided as the continent they grew up on. Separated throughout their youth by the Iron Curtain, Ms. Lagarde was a member of France's national team for synchronized swimming. Ms. Merkel famously needed an entire swimming class to muster the courage to jump off the diving board.

Once they entered politics, their climbs were similarly swift. Ms. Merkel was the head of Germany's largest party, the Christian Democratic Union, just 10 years after joining in 1990. She beat out career politicians to win the chancellorship just five years later, in 2005. Ms. Lagarde won the post at the top of the I.M.F. a mere six years after joining the French government as trade minister in 2005.

The roots of the personal relationship between the two leaders began when Ms. Lagarde became the first and only member of a foreign government to sit in on a German cabinet meeting in March 2010, taking her place across the large chancellery conference table from Ms. Merkel.

"It was a very moving moment, because she made a point of inviting me and nobody else," Ms. Lagarde said.

In the year since Ms. Lagarde took over her post as the head of the I.M.F. after her predecessor, Dominique Strauss-Kahn, was accused of sexual assault, the two have come yet closer. They frequently disagree about policies in meetings, officials at the negotiating table note. But they tend to do so with an understanding of the other's political constraints, and an appreciation for the shared goal of stabilizing the world economy, Europe first.

Over the winter, the I.M.F. economists stress-tested the world and saw the need for the additional $1 trillion in lending capacity to aid ailing states. About half the need stemmed directly from Europe, so the I.M.F. asked the European Union to add about $500 billion in capacity to its firewall. The fund would then raise the other $500 billion.

But European countries have balked at adding to their bailout fund, which as of this summer will be known as the European Stability Mechanism. "We should not continuously have this discussion about the size of the firewall," said Luc Frieden, the finance minister of Luxembourg. "It's like a discussion about the number of firefighters you have in a city. If the whole city burns down, you'd never have enough."

The I.M.F. funding has also proved divisive. The United States, the fund's only shareholder with effective veto power, has staunchly refused to provide further financing, urging the Europeans to solve their own problems. "The I.M.F. cannot move forward without more clarity on Europe's own plans," the U.S. Treasury secretary, Timothy F. Geithner, said at a Group of 20 finance meeting last month in Mexico City.

For Ms. Lagarde, patience is necessary, as well as understanding for Ms. Merkel's deeply analytical, scientific approach. "You have to continuously explain, rationalize, dissect the whys, the pros and the cons and plead your case," Ms. Lagarde said. "It's the lawyer and the physicist," she added. "I will continue to grit my teeth and smile and keep up the work."

Annie Lowrey reported from Washington. Liz Alderman contributed reporting from Paris.

Europe told not to neglect growth

PARIS

Continent has put itself in a fiscal straitjacket, former U.S. official says

BY LIZ ALDERMAN

Greece skirted disaster Friday with a landmark bond swap deal that clears the way for billions of euros in bailout funds. But, in the view of one of the world's leading economists who is also a former top U.S. policy maker, the fiscal straitjacket constructed by European leaders to avoid the need for a rerun of the Greek drama in other countries may create fresh problems in the euro zone.

"Europe has turned a corner, but that doesn't mean it's out of the woods," Lawrence H. Summers, director of the White House National Economic Council for the first two years of President Barack Obama's tenure, said in Paris on Friday. "There's a tendency for the avatars of austerity to neglect the effect on growth."

A plan voted this month by leaders in Brussels to impose fiscal discipline by requiring every member of the euro zone to meet strict budget targets is pushing Spain and Portugal, in particular, back to the center of worries even as fears of an unruly Greek bankruptcy fade.

Spain, for one, is pushing back. Prime Minister Mariano Rajoy raised hackles recently in Brussels by declaring that he planned to breach the euro zone's new fiscal pact because his country was facing a deep downturn amid a staggering 22.8 percent jobless rate.

The Spanish government this month said its budget deficit for 2011 was sharply higher than expected. Mr. Rajoy has said he does not intend to worsen things with overly sharp deficit cuts, demanded by Brussels, that could push the economy further into a downward spiral.

The European Commission said Friday that several of its inspectors visited Madrid this week to examine the country's public accounts.

In Portugal, Prime Minister Pedro Passos Coelho has embarked on an ambitious program of spending cuts and tax increases to lower a mountain of debt. But Portugal's finances are worsening as it slides into a deep and painful recession. The economy is expected to contract more than 3 percent this year after shrinking 1.6 percent last year, the government said Friday.

Portugal had to pay higher interest rates Friday on its benchmark bond amid speculation that the country might, like Greece, need to ask for a second bailout. The yield on the 10-year bond rose for the third straight day, to nearly 14 percent. The higher Portugal's borrowing costs, of course, the more likely it is that it will have to seek another bailout.

J. SCOTT APPLEWHITE/AP

Lawrence Summers, a former U.S. Treasury secretary, said Germany could help Europe by encouraging spending at home.

Together with Greece, whose economy has also plunged into a deep recession, the predicament of countries on Europe's southern rim raises the question of whether Germany and other healthier European countries should be doing more to stimulate growth in their own countries to make up for the need to reduce debts in southern Europe.

"You can't really claim there's a viable growth model for Europe," Mr. Summers said at a conference sponsored by the Académie Diplomatique Internationale and the International Herald Tribune in cooperation with the Harvard Kennedy School. "I challenge the idea that rapid consolidation constitutes a growth strategy."

The fever of the euro crisis has cooled sharply, partly because of measures European politicians have taken to strengthen the euro's foundations but mostly in response to a sharp easing of monetary policy by the European Central Bank and hugely increased lending to European banks.

In Italy, Prime Minister Mario Monti's efforts to reduce the country's debt load, one of the euro zone's highest, have helped lower the high interest rates that investors were forcing the country to pay, soothing the nervousness that had spread to other troubled euro countries.

Yields on Spanish bonds had also been falling until Mr. Rajoy acknowledged that the government's 2011 deficit was higher than previously thought, at 8.5 percent, well above its 6 percent goal.

But with growth continuing to erode along the southern tier, one of the biggest issues facing Europe is the role Germany should play in shoring up the euro zone.

Mr. Summers suggested that Germany, which has benefited from its exports to Spain, Greece, Portugal and other southern euro zone countries, should help those economies by doing more to encourage consumer spending at home, rather than following its own prescription of austerity for others.

"Germany sees its economic model as one others should emulate," Mr. Summers said. "But it is dependent on export-led growth while southern Europe will have a smaller excess of imports.

"The question is," he said, "where is the greater importing going to come from?"

In next cash crunch, Greece may need new tactics

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wretched state — fourth-quarter G.D.P. shrank 7.5 percent in 2011 and youth unemployment at 51 percent is now officially the highest in Europe — it is by no means clear that Athens will be able to generate the cash to service its remaining debt.

Analysts differ on the size of the financing gap that Greece will face in the next two years — in effect the sum of money that it will need to fulfill its internal and external obligations. J.P. Morgan put the figure at €20 billion in a research note Friday, and others have said the amount may be twice that. It is a fluid estimate, highly sensitive to hard-to-predict factors like growth and privatization revenues.

Highlighting still-present doubts over Greece's fiscal health, Fitch on Friday became the third credit ratings agency to downgrade the country, giving it a rating of restricted default. Fitch said it would upgrade Greece following a successful completion of the debt exchange, expected at the end of the month.

Nevertheless, in the short term the debt deal has saved Greece from a disorderly default and exit from the euro. As previously agreed, euro zone leaders are now expected to sign off on the €130 billion in stopgap financing that Greece needs for this year. On March 15, the I.M.F is expected to approve its part of the Greek package.

There will also be some last-minute wrangling over what to do with the remaining investors holding so-called foreign law bonds, issued under other legal regimes than Greece's, who have declined to participate in the transaction. The Greek government said Friday that it had extended its offer to these bondholders to March 23 and that the offer would be pulled after that date.

Analysts say they expect some holdout investors to sue but add that it is unlikely the dissidents will be able to hold up Greece or Europe for a better deal, given their fairly small number.

They point out that there might even be an upside to the public sector's being Greece's largest creditor: It might be easier for creditor nations to take collective steps to aid Greece before the crisis hits, as opposed to trying to persuade a diffuse community of investors with different interests and agendas to climb aboard at a loss.