

Echoes of Subprime Ring Out Across Greek Crisis

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In June 1992, Greece issued five-year bonds with a face value of \$250m at a rate of 8.25 per cent. The spread between the five year Greek bond and the equivalent German Bund was roughly 228 basis points. Greece had a deficit of 11.5 per cent of GDP and a debt to GDP ratio of 110 per cent. Its S&P credit rating was a miserable BBB-.

In June 2008, Greece issued five-year bonds with a face value of \$1.5bn, at an interest rate of 4.625 per cent. This time the spread with the equivalent German Bund was only 113bps, half of what it had been in 1992. Greece's S&P rating was now a respectable A. Yet the underlying numbers had not improved that much. The deficit was 5 per cent of GDP and the ratio of debt to GDP was 98 per cent. And Greece was known to have fudged its financial health in official data.

There's more. In the early 1990s, Greek debt contracts had numerous provisions that protected creditors from default. The debt contracts gave bondholders the right to accelerate upon an event of default. They committed Greece to membership in the International Monetary Fund and access to IMF funding — which meant monitoring by the IMF. And it appears (although it is hard to verify) that a major portion of Greece's external debt was governed by some combination of English and US law. In the early 1990s, the credit market treated Greece as a third world country — like Ecuador or Venezuela.

By 2006, the contractual protections for external creditors had been narrowed. In its English law bonds, the right of acceleration could now be exercised only with the consent of bondholders holding 25 per cent of the outstanding debt. Greece also no longer had to retain membership in the IMF with access to its lines of credit. Most important, a large fraction of the bonds held by external creditors was now governed by Greek law. This meant that Greece could unilaterally restructure the debt simply by changing its law. Investors had promoted Greece from third-world debtor to first-world debtor while its finances remained third-world.

What could account for this change? Greece joined the eurozone in 2001. But why should the market have cared that Greece entered the eurozone when its finances did not improve?

The answer is probably that the market believed that either eurozone countries would discipline Greece's financial excesses or bail out Greece if they failed. If so, the irony is palpable. Greece (like most other eurozone countries) did not comply with a treaty provision requiring financial discipline but was allowed into the eurozone anyway. Investors must have reasoned that if the treaty provision governing financial discipline could be ignored, then the treaty provision banning bail-outs could be ignored as well. And they were right. But if the treaty could be ignored, then why would entering a treaty make a difference to Greece's creditworthiness in the first place?

We suspect that the story is about politics, not economics. In their effort to press forward with European integration, political elites sought monetary union in the hope that it would forge bonds between still mutually suspicious nationalities. But monetary (and political) union cannot

succeed when vast disparities of wealth exist across regions, and the people of northern European countries had no interest in correcting these disparities by transferring wealth to the south.

Political elites squared this circle by (we suspect) encouraging national banks to buy up Greek debt despite reservations about its quality — so that transfers would take place but disguised as credit made cheap by implicit government guarantees. Apparently, the European Central Bank accepted Greek debt as collateral for loans on the same terms that it accepted the debt of more financially stable countries. European commercial banks would then devour Greek debt because it was liquid and secure, and paid a premium over the debt of safer countries — plus they received certain regulatory advantages because it was EU sovereign paper.

The rest is history. The parallel between the Greek debt crisis and the subprime crisis is striking. Trashy debt is alchemised to gold through manipulations driven by a political agenda. In the case of subprime debt, this took the form of collateralised debt obligations consisting of government-supported mortgage-backed securities. In the case of Greek bonds, it was European Monetary Union. Subprime debt, long believed to be risky, magically becomes almost as safe as Treasury bonds. Greece, which has spent half its existence as an independent nation in default, magically becomes almost as creditworthy as Germany. In both cases, investors expected to be bailed out, and were. In both cases, politically motivated wealth transfers were disguised as cheap credit. In both cases, taxpayers who resisted cash transfers to low-income groups found out later that they had to pay for what they did not want because the alternative was financial Armageddon.

Eric Posner is Kirkland and Ellis Professor of Law, University of Chicago. This piece was co-authored by Mitu Gulati, professor at Duke Law School