Bondholders need to step up in Greece

Yannis Behrakis/Reuters

A masked youth walks beside a burning barricade during clashes in Athens' central Syntagma (Constitution) Square.

Tim Shufelt Jun 16, 2011 – 6:28 PM ET | **Last Updated: Jun 16, 2011 6:31 PM ET**

As the Greece crisis began to destabilize wider financial markets on Thursday, Canada's former top central banker added his voice to those advocating a solution involving bondholders taking a hit, a position that Europe's captains of finance have strenuously resisted.

"You can kick the can down the road in the hope that something is going to come along. Well, something isn't going to come along in this case, and our group thinks private holders of debt should be willing to look at doing something," David Dodge said in London, on behalf of the Institute of International Finance, an independent group of influential bankers and investors.

A package that shares the burden of bailing out Greece is the "least risky" solution, he said. "The longer you let it go, the greater the chance that another event will come along and create a bigger problem."

Mr. Dodge's comments came after a day of drama in Greece that stretched market nerves to the limit. Some are now worrying that that Europe is now facing its "Lehman" moment.

"The probability of a eurozone Lehman moment is increasing," said Neil Mackinnon, an economist at VTB Capital in London. "The markets have moved from simply pricing in a high probability of a Greek debt default to looking at a scenario of it becoming disorderly and of contagion spreading to other economies like Portugal, like Ireland, and maybe Spain, Italy and Belgium."

The euro fell to a record low against the Swiss franc and slid against the dollar and the yen on Thursday as investors fled to safe-haven assets on mounting concerns that Greece's problem are far from resolution.

There were also signs on money markets of growing tension in inter-bank lending, as occurred when the Greek debt crisis erupted early last year.

Late on Thursday Prime Minister George Papandreou announced he would delay a reshuffle of his cabinet until Friday morning, continuing the uncertainty in the country's leadership.

Meanwhile, the European Union's top economic official, Olli Rehn, said he expected the EU and the International Monetary Fund to release a crucial 12 billion euro loan tranche in early July to keep Athens afloat.

Ultimately, the fate of Greece hinges on one crucial question: Should those holding Greek debt be made to share the pain?

Dissension on whether the private sector should participate in the bloodletting has pitted the core of the European Union against the periphery, the region's most powerful bankers against those bankrolling the bailouts, and the people of Greece against their own government.

Mr. Dodge's perspective is certainly shared by taxpayers in Greece, enraged by the notion of suffering strict austerity measures while Europe's banks are made whole, and those throughout the eurozone embittered by funding multibillion-euro rescue packages. Germany, for one, favours a bond swap that would extend maturities on Greek bonds by seven years.

Those firmly entrenched against a restructuring of Greek debt, include Europe's banking system, the European Central Bank, and the International Monetary Fund.

They warn of a potential catastrophic banking crisis that could reverberate from Greece through the eurozone.

"Having private sector participation is easier said than done without triggering a bigger crisis," said Marc Chandler, global head of currency strategy at Brown Brothers Harriman. Mr. Chandler said such a scenario could be a potential Lehman-type event.

Something like a bond swap would be regarded by ratings agencies as a "selective default," thus triggering a potential major credit event in Europe, Mr. Chandler said.

"A good part of Greek banks are wiped out. Anybody who has Greek bank bonds gets wiped out," he said.

Large banks throughout Europe, with extensive holdings of Greek sovereign bonds, are also vulnerable, a risk made clear when Moody's Investors Service put three of France's biggest banks on credit watch because of exposure to risky debt.

A Greek restructuring could also compel other countries in the periphery to take the same route, possibly unleashing an uncontainable contagion of sovereign defaults that could cripple the region's banking system.

Alex Jurshevski, founder of Toronto-based Recovery Partners and an expert in sovereign restructurings, said the violence that continues to grip Athens was perfectly predictable given that officials have tried to impose a "creditor friendly" bailout.

"The policy makers in Europe and the IMF people have made a huge blunder here," he said. "They imposed a solution that has reduced the degrees of freedom going forward and has contributed to massive social unrest."

By stumbling through the sovereign debt crisis by implementing a series of stopgap bailouts, authorities effectively increased the cost of a refinancing, which is inevitable, Mr. Jurshevski said. "You can't have a solution in these scenarios where somebody walks away from the table whole. It's completely unsustainable," he said.

With files from Reuters and Bloomberg