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Guest Contribution: Greek Bond Buyback Boondoggle

ByGuest Contributor

Klaus Adam, an economic professor at University of Mannheim and Bundesbank Research Professor, is skeptical of a proposal for the ECB to repurchase Greek bonds issued to private creditors.

The Greek bailout is badly off track. The International Monetary Fund has been pushing the euro zone to find ways to reduce Greece's debt, but euro-zone governments and the European Central Bank, which holds around 50 billion euros of Greek bonds, have resisted any suggestion that they should forgive any of the debt owed to them.

At this point enters a proposal by ECB's Board Member Jörg Asmussen to repurchase some (or even all) of the Greek bonds issued to private creditors after they agreed to take a 53.5% loss on the face value of their bonds earlier this year. Those bonds have a face value of 63 billion euros but currently trade at a steep discount. The argument put forward in favor of such a buyback is that it increases Greece's debt sustainability without requiring additional funds.

In a classic economic paper Harvard's Ken Rogoff and Stanford's Jeremy Bulow have exposed the flaws of this line of reasoning. They show that – unless additional lines of credit are given to the country or other material concessions are made – a buyback will entail a huge wealth transfer from the borrower to the lender. Since the point of the currently proposed buyback is to avoid having to make additional material concessions, the proposed Greek buyback will necessarily result in a resource transfer of this kind, thereby hurting Greece. This is exactly the opposite of what the IMF has been proposing.

Why is it that buybacks achieve the opposite of what they are supposed to be doing? The argument is surprisingly simple, but only once you've heard it. Consider a country which can repay 1 euro but has outstanding debt with a face value of 2 euros, so that all debt trades at 50 cents on the euro. Now suppose that the country – through whatever operation – receives an additional 50 cents and uses it to repurchase outstanding debt with a face value of 1 euro. Note that this is an optimistic assumption, as it assumes that the country can buy back half of its debt at the price prevailing before the buyback program started (50 cents on the euro). The country will then be left with 1 Euro of outstanding debt and can still pay back 1 euro, so that the remaining debt now suddenly trades at its face value.

What has happened? The additional 50 cents of resources that the country has spent have been transferred in their entirety to the country's lenders, who now receive back 1.5 euros instead of just 1 euro.

How could this happen? Essentially, the country repurchases debt at the average price, i.e., at 50 cents on the Euro, but reduces debt only at the margin. Yet, the marginal value of debt is close zero for a country that is close to default, so that a debt buyback has negative value for the country.

It is hard to see that the ECB fails to understand such a simple but powerful argument, which raises the question of why it sees value in pursuing the bond buyback option. While one can only speculate as to why this happens, it seems that the implicit support to the banking system that is ultimately provided by a buyback may be at the heart of the proposed operation.