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It's Time for the EU to Embrace Haircuts on Greek Debt

European taxpayers have already lost money on loans to Greece. EU lenders should accept a haircut on Greek debt to shield them from even greater losses.

The current debate about whether to take a "haircut" in Greek debt is somewhat surrealistic for any observer familiar with basic finance concepts such as discounted cash flow. Politicians seem to believe (or better, want to make the voters believe) that as long as they have not written down the face value of debt they have not lost taxpayers money. For example, on July 14 Johan Van Overtveldt, Belgian minister of Finance said that it will take a long time before the loans to Greece are repaid , but as long as the nominal value of the debt is not changed there is no loss to taxpayers. In a July 20 interview on CNBC Jean-Claude Trichet, former ECB president made a similar statement saying that members of the European Union are simply unwilling to accept taxpayer's losses and suggested lowering interest rates and lengthening the maturity of the debt.

Politicians are also helped by so called experts who point out that governments earn a "profit" on their loans: they borrow at 1 percent and lend to Greece at 2 percent. But this reasoning confuses accounting profit with economic profit: economic profitability requires compensation for the default risk of Greek debt. The low interest rates of Euro countries reflect their own risk, not the risk of Greek long term debt.

Well, I have bad news for EU taxpayers: you already have lost more than half the money your representatives have lent to Greece, but they are afraid to tell you. The value of the debt is not the face value of the debt but the present value of expected cash flows (interest payments plus principal). The appropriate discount rate is not the borrowing rate of the lender but the opportunity cost of capital: the rate of return investors require to invest in assets with similar risk, in this case long term Greek government bonds. The Greek government has borrowed more than 300 billion euro from the IMF, The European Central Bank, and the EU. **Since 2011 the average maturity of these loans is 16 years and the average interest rate is around 2 percent.** The interest rates are very low, well below rates that reflect the default risk of Greek government debt. Currently **yields on long term Greek government bonds are close to 9 percent**, reflecting the market's expectation that Greece will be unable to repay its debt mountain. The present value (discount rate of 9 percent) of a 16 year bond with a nominal value of 100 euro and a 2 percent coupon is approximately 41.81 euro. So taxpayers have already lost 58 percent of their money.

How deception increases costs to taxpayers.

The attempt to hide losses from bad loans may produce additional losses to taxpayers. Indeed, Euro politicians, instead of accepting a haircut and lowering the nominal value, apparently prefer to lower interest rates and lengthen the maturity of the debt. If, in our numerical example you lower the interest rate to 1 percent and lengthen the maturity to 25 years, the value of the bond falls to 21 euros, increasing the loss from 58 percent to 79 percent. If instead lenders would take a 30 percent haircut and lower the face value to 70 Euros and keep interest rates at 2 percent, the bond's value would fall as well, but only to 29 Euros. Moreover, lowering the principal will lower the probability of default and therefore the yield on the bonds. If, for example, the yield would fall from 9 percent to 6 percent, the value of the bond would increase to 41.7 Euro. If the yield would fall to 5 percent, the bond value would rise to 47.5 Euros, more than twice the value if the lenders would go ahead with the lowering the interest rate and extending maturity. Note that, unlike lowering the face value of the debt, extending maturity does not make it more likely that Greece will pay back the principal. Indeed it is not obvious that Greece will be more fiscally responsible 25 years from now than 16 years from now. So, deception is costly. Taking a haircut may actually be far better for taxpayers than the alternatives currently considered.

Politicians have been the hardest critics of bankers for making bad loans and blaming it on banker's bonuses. In all fairness they should now hold themselves to the same standards and admit they made bad loans themselves. They could argue that they did not do it for vulgar objectives such as bonuses, but for saving the badly designed Economic and Monetary Union (EMU) project.

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