THE WALL STREET JOURNAL.

Is Greece's Debt Worth the Risk?

By Marcello Minenna

Ahead of Monday's emergency summit of eurozone leaders to discuss Greece, there's a real danger the negotiations are stalling on the wrong points. Creditors insist on significant increases in revenue from the value-added tax and deeper cuts to pension spending, both of which Athens is resisting by offering competing revenue-raising measures.

Germany, especially, is unlikely to offer reductions to Greece's enormous debt burden under current circumstances. But Greece's crushing postbailout debt burden remains a drag on economic growth, which will only compound the effects of other anti-growth measures that are being discussed, such as VAT hikes. The deteriorated financial position of pensions arises not only from excessively generous benefits but also from the fact that the government already has had to raid pension funds in order to make debt payments—and may well need to do so in the future.

Not for nothing does one of Greece's creditors, the International Monetary Fund, argue for debt relief. European governments that now hold the bulk of Greece's debt should recognize that they've already taken a loss on those holdings and move on.

To see how this would work, imagine that all of Greece's outstanding debts were consolidated into one bond representing the total size and average maturity and interest rate of the debt. It would have a face value above €310 billion ($352.02 billion), a maturity of 16 years and an annual coupon rate of 2.7%, amounting to €8 billion of interest payments per year. The face value of this stylized "bond" would be more than 175% of Greece's gross domestic product.

Debt relief should start with these assumptions and then work backward to what the market value of such a bond would be were Greece to issue it today. One way of doing this is to assume we are no better off now than we were during Greece's last crisis, in March 2012, which is the last time a significant tranche of Greece's debt was held in the private sector. The restructuring back then imposed an effective haircut of 70% on bond holders. By the same token, today's spreads on the small portion of Greece's debt that is in private hands suggest a market price of around half the face value. Hence the market would value Greece's stylized "bond" at €140 billion.

Under a pragmatic agreement Greece could swap its nominal debt with a new debt of that size. This would bring the country's debt-to-GDP ratio down to 75%, in line with Germany. Shifting to a 30-year maturity and a zero coupon would also ease Greece's current fiscal burden.

Convincing taxpayers in countries that hold Greece's debt, especially Germany, to accept such a deal might be difficult. But they need to understand that this is the extreme consequence of the abnormal co-existence within the eurozone of multiple sovereign yield curves. They also need to understand, before it's too late, that this is the least bad option. A debt restructuring now could allow Greece's sovereign creditors to manage their losses and spread it over the life of Greece's debt. In contrast, the uncontrolled default that could occur if a deal isn't reached would force an immediate recognition of a haircut.

In this perspective, the European Financial Stability Facility could become the vehicle to preliminarily take over the debt of other creditors, such as the IMF, and consolidate the whole Greek debt. Once Greece's debt is swapped at market value within the EFSF facilities, the only financial commitment to be handled by the member states would be the coupon payments of the EFSF's own outstanding debt and its refinancing according to proper guarantee schemes.

By doing so the eurozone will have a prompt risk-management tool in order to easily steer timing and amount of losses that each member state would be required to face. This steering power would also be magnified by the fact that EFSF's bonds are eligible for purchase by the European Central Bank under its program to purchase sovereign debt—or quantitative easing.

Meanwhile, the cancellation of €8 billion of annual interest payments could ease future Greek debt management by helping the convergence of refinancing costs toward the German level, characterized by negative or zero interest. This would provide Athens with political breathing room to implement the reforms it needs.

Creditors are concerned about moral hazard, and in one sense a market-based method for debt relief would "reward" the controversial fiscal and policy behavior that has so badly dented investor faith in the Greek government. But negotiators are out of any other options to put Greece on a sustainable path. If eurozone leaders aren't prepared for an uncontrolled default, it's time to revisit Greece's unsustainable level of debt.

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> Talks about reforms would go a lot smoother if creditors recognized their losses and moved on.