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Wall St. Helped to Mask Debt Fueling Europe's Crisis

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Wall Street tactics akin to the ones that fostered subprime mortgages in America have worsened the financial crisis shaking Greece and undermining the euro by enabling European governments to hide their mounting debts.

As worries over Greece rattle world markets, records and interviews show that with Wall Street's help, the nation engaged in a decade-long effort to skirt European debt limits. One deal created by Goldman Sachs helped obscure billions in debt from the budget overseers in Brussels.

Even as the crisis was nearing the flashpoint, banks were searching for ways to help Greece forestall the day of reckoning. In early November — three months before Athens became the epicenter of global financial anxiety — a team from Goldman Sachs arrived in the ancient city with a very modern proposition for a government struggling to pay its bills, according to two people who were briefed on the meeting.

The bankers, led by Goldman's president, Gary D. Cohn, held out a financing instrument that would have pushed debt from Greece's health care system far into the future, much as when strapped homeowners take out second mortgages to pay off their credit cards.

It had worked before. In 2001, just after Greece was admitted to Europe's monetary union, Goldman helped the government quietly borrow billions, people familiar with the transaction said. That deal, hidden from public view because it was treated as a currency trade rather than a loan, helped Athens to meet Europe's deficit rules while continuing to spend beyond its means.

Athens did not pursue the latest Goldman proposal, but with Greece groaning under the weight of its debts and with its richer neighbors vowing to come to its aid, the deals over the last decade are raising questions about Wall Street's role in the world's latest financial drama.

As in the American subprime crisis and the implosion of the American International Group, financial derivatives played a role in the run-up of Greek debt. Instruments developed by Goldman Sachs, JPMorgan Chase and a wide range of other banks enabled politicians to mask additional borrowing in Greece, Italy and possibly elsewhere.

In dozens of deals across the Continent, banks provided cash upfront in return for government payments in the future, with those liabilities then left off the books. Greece, for example, traded away the rights to airport fees and lottery proceeds in years to come.

Critics say that such deals, because they are not recorded as loans, mislead investors and regulators about the depth of a country's liabilities.

Some of the Greek deals were named after figures in Greek mythology. One of them, for instance, was called Aeolos, after the god of the winds.

The crisis in Greece poses the most significant challenge yet to Europe's common currency, the euro, and the

Continent's goal of economic unity. The country is, in the argot of banking, too big to be allowed to fail. Greece owes the world $300 billion, and major banks are on the hook for much of that debt. A default would reverberate around the globe.

A spokeswoman for the Greek finance ministry said the government had met with many banks in recent months and had not committed to any bank's offers. All debt financings "are conducted in an effort of transparency," she said. Goldman and JPMorgan declined to comment.

While Wall Street's handiwork in Europe has received little attention on this side of the Atlantic, it has been sharply criticized in Greece and in magazines like Der Spiegel in Germany.

"Politicians want to pass the ball forward, and if a banker can show them a way to pass a problem to the future, they will fall for it," said Gikas A. Hardouvelis, an economist and former government official who helped write a recent report on Greece's accounting policies.

Wall Street did not create Europe's debt problem. But bankers enabled Greece and others to borrow beyond their means, in deals that were perfectly legal. Few rules govern how nations can borrow the money they need for expenses like the military and health care. The market for sovereign debt — the Wall Street term for loans to governments — is as unfettered as it is vast.

"If a government wants to cheat, it can cheat," said Garry Schinasi, a veteran of the International Monetary Fund's capital markets surveillance unit, which monitors vulnerability in global capital markets.

Banks eagerly exploited what was, for them, a highly lucrative symbiosis with free-spending governments. While Greece did not take advantage of Goldman's proposal in November 2009, it had paid the bank about $300 million in fees for arranging the 2001 transaction, according to several bankers familiar with the deal.

Such derivatives, which are not openly documented or disclosed, add to the uncertainty over how deep the troubles go in Greece and which other governments might have used similar off-balance sheet accounting.

The tide of fear is now washing over other economically troubled countries on the periphery of Europe, making it more expensive for Italy, Spain and Portugal to borrow.

For all the benefits of uniting Europe with one currency, the birth of the euro came with an original sin: countries like Italy and Greece entered the monetary union with bigger deficits than the ones permitted under the treaty that created the currency. Rather than raise taxes or reduce spending, however, these governments artificially reduced their deficits with derivatives.

Derivatives do not have to be sinister. The 2001 transaction involved a type of derivative known as a swap. One such instrument, called an interest-rate swap, can help companies and countries cope with swings in their borrowing costs by exchanging fixed-rate payments for floating-rate ones, or vice versa. Another kind, a currency swap, can minimize the impact of volatile foreign exchange rates.

But with the help of JPMorgan, Italy was able to do more than that. Despite persistently high deficits, a 1996 derivative helped bring Italy's budget into line by swapping currency with JPMorgan at a favorable exchange rate, effectively putting more money in the government's hands. In return, Italy committed to future payments that were not booked as liabilities.

"Derivatives are a very useful instrument," said Gustavo Piga, an economics professor who wrote a report for the Council on Foreign Relations on the Italian transaction. "They just become bad if they're used to window-dress accounts."

In Greece, the financial wizardry went even further. In what amounted to a garage sale on a national scale, Greek officials essentially mortgaged the country's airports and highways to raise much-needed money.

Aeolos, a legal entity created in 2001, helped Greece reduce the debt on its balance sheet that year. As part of the deal, Greece got cash upfront in return for pledging future landing fees at the country's airports. A similar deal in 2000 called Ariadne devoured the revenue that the government collected from its national lottery. Greece, however, classified those transactions as sales, not loans, despite doubts by many critics.

These kinds of deals have been controversial within government circles for years. As far back as 2000, European finance ministers fiercely debated whether derivative deals used for creative accounting should be disclosed.

The answer was no. But in 2002, accounting disclosure was required for many entities like Aeolos and Ariadne that did not appear on nations' balance sheets, prompting governments to restate such deals as loans rather than sales.

Still, as recently as 2008, Eurostat, the European Union's statistics agency, reported that "in a number of instances, the observed securitization operations seem to have been purportedly designed to achieve a given accounting result, irrespective of the economic merit of the operation."

While such accounting gimmicks may be beneficial in the short run, over time they can prove disastrous.

George Alogoskoufis, who became Greece's finance minister in a political party shift after the Goldman deal, criticized the transaction in the Parliament in 2005. The deal, Mr. Alogoskoufis argued, would saddle the government with big payments to Goldman until 2019.

Mr. Alogoskoufis, who stepped down a year ago, said in an e-mail message last week that Goldman later agreed to reconfigure the deal "to restore its good will with the republic." He said the new design was better for Greece than the old one.

In 2005, Goldman sold the interest rate swap to the National Bank of Greece, the country's largest bank, according to two people briefed on the transaction.

In 2008, Goldman helped the bank put the swap into a legal entity called Titlos. But the bank retained the bonds that Titlos issued, according to Dealogic, a financial research firm, for use as collateral to borrow even more from the European Central Bank.

Edward Manchester, a senior vice president at the Moody's credit rating agency, said the deal would ultimately be a money-loser for Greece because of its long-term payment obligations.

Referring to the Titlos swap with the government of Greece, he said: "This swap is always going to be unprofitable for the Greek government."