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Debt reduction without default?

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Abstract

This paper proposes a two-step, market-based approach to debt reduction:

Step 1. The European Financial Stability Facility (EFSF) would offer holders of debt of the countries with an EFSF programme (probably Greece, Ireland and Portugal = GIP) an exchange into EFSF paper at the market price prior to their entry into an EFSF-funded programme. The offer would be valid for 90 days. Banks would be forced in the context of the ongoing stress tests to write down even their banking book and thus would have an incentive to accept the offer.

Step 2. Once the EFSF had acquired most of the GIP debt, it would assess debt sustainability country by country.

a) If the market price discount at which it acquired the bonds is enough to ensure sustainability, the EFSF will write down the nominal value of its claims to this amount, provided the country agrees to additional adjustment efforts (and, in some cases, asset sales).

b) If under a central scenario this discount is not enough to ensure sustainability, the EFSF might agree on a lower interest rate, but with GDP warrants to participate in the upside.

A key condition for this approach to succeed in restoring access to private capital markets is that the EFSF claims are *not* made senior to the remaining claims and the new private bondholders. EFSF support must be comparable to an injection of equity into the country.

While the EFSF concentrates on the exchange of the stock of bonds, the IMF could fund the remaining deficits in the usual way with bridge financing, until the fiscal adjustment is completed. The ECB would of course immediately stop its 'Securities Market Programme', which would have lost its *raison d'être*.

Introduction: The dilemma

The EU resembles a group of highly interdependent companies with large cross-holdings of equity stakes. However, the formal structure of the group is very light. There is no central authority that can give orders to individual members of the group. When a subgroup of the EU member countries decided about ten years ago to adopt the same financing instrument, they acknowledged this limitation and created only a 'special purpose vehicle' (the ECB) with the very narrow remit to look after the stability of their common currency. The articles of incorporation of EMU also stated explicitly that it was to remain a 'limited liability' community because of this lack of powers of the central authorities of the group.

However, in early 2010, one of its members got into trouble and the others discovered that financial markets had become so integrated that they could not seriously contemplate a failure of a fellow euro-area country. Hence, even the most reluctant creditor countries agreed to a €110 billion adjustment programme for Greece on the assumption that a combination of fiscal and structural adjustment would stabilise public debt and allow the country to regain market access soon. One year on, however, the situation has not improved. On the contrary, other member countries have experienced difficulties in accessing funds at reasonable rates. One of them, Ireland, was shut out of the market when the true scale of the losses in its banking system finally

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emerged. And, in the case of Greece, the debt dynamics has not turned around, nor has market access been restored.

The euro area thus can no longer avoid facing the stark choice it wanted to evade in 2010: either it sticks to the 'limited liability' character of EMU (but in this case a sovereign default becomes likely), or it moves towards a fiscal union with a mutual guarantee for the public debt of all member countries. We regard the latter as dangerous, because without political union it would be open to legal challenges and would alienate the German electorate.

The purpose of this note is to show a way out of this dilemma. In our view, the present crisis could be managed without changing the 'limited liability' character of EMU.

We proceed in the following way. We start in section 1 by analysing the fundamental issues raised by the construction of EMU as an asymmetric system. We then turn to the legacy of the 2010 decisions on the EFSF, together with the results of the European Council of October of that year. Section 3 briefly summarises the main steps to be taken, which are then detailed in the remainder of this note.

1. Managing the euro: An unresolved issue of symmetry

An important motive for the launch of the euro was the desire to replace the monetary policy of the Bundesbank, which was said to have 'asymmetric effects' on Europe. Designed for Germany, it was 'exported' to other European countries, where it often did not fit economic conditions, through the quasi-fixed exchange rates of the European Monetary System. By forming a monetary union and committing the central bank to maintaining price stability on average within the union, the asymmetric policy of the Bundesbank was replaced by the symmetric policy of the ECB. However, since a political union to complement and fortify monetary union was rejected, a commensurate symmetrical fiscal union, where deficits of one region would be funded by surpluses in another region, was not on the agenda. Instead, each member country of EMU was supposed to exert a degree of fiscal policy discipline consistent with price stability in the euro area. To reinforce fiscal discipline, the Stability and Growth Pact was concluded, which somewhat implausibly envisaged that the same EMU member countries that refused to give up national sovereignty in a political union would accept an infringement of their fiscal policy sovereignty by European Union institutions. This unwillingness to cede fiscal sovereignty persists even today as can be seen from the fact that the proposal to make the sanctions under the SGP automatic had to be abandoned because most member states were not willing to accept this limitation of political discretion.

As long as the disciplinary influence of the markets was suspended by the inflation of the global credit bubble, the absence of a symmetrical fiscal policy did not set a binding constraint on the run-up of big fiscal and external deficits and debt by certain peripheral EMU countries. The ratings agencies with their pro-cyclical assessments reinforced this tendency as the fundamentals of these countries (in particular their growth rates) appeared good. They did not notice that the high ratings sustained the very capital inflows that were behind these high growth rates.

Although the Stability and Growth Pact envisaged monetary fines for the breach of fiscal discipline, such sanctions were never imposed. The Pact was applied only leniently for countries with clear fiscal problems, such as Greece, and was even changed in 2004 to avoid fines for Germany and France.

The impression that sovereign lending inside the euro area was riskless was further reinforced by two regulatory choices: i) the capital adequacy rules of the ECB have a zero risk weighting for public debt of euro area member countries, and ii) the ECB did not apply any graduated haircuts to the public debt instruments it receives as collateral.

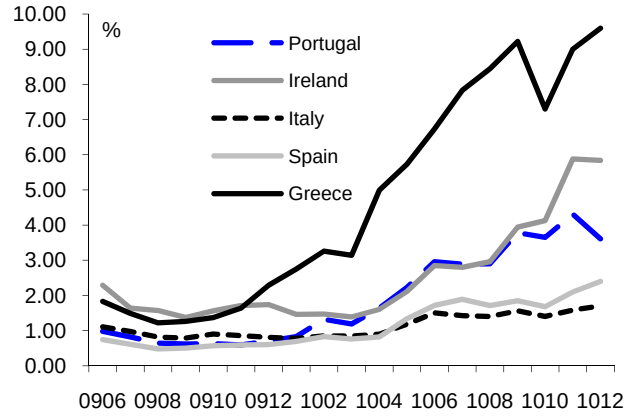
With rising risk aversion of investors since the beginning of the financial crisis in 2007, markets suddenly took fright at bloated government budget deficits and exorbitant debt levels (Figure 1).[1] Gros (2010c) shows how the combination of a drop in expected growth potential and an increased risk premium can fundamentally alter any sustainability assessment.

Some countries (and their banks), deemed over-indebted by the market, have now been shut off from market funding of their expiring old and upcoming new debt. That this applies to all of their debt is a new experience, as governments usually have recourse to the central bank to fund their domestic debt issuance via money creation as a measure of last resort. With the euro area community so far having failed to calm markets by providing financial assistance programmes to countries in trouble, a growing number of observers and market participants see no alternative to accepting this 'fiscal dominance' of monetary policy at the euro area level, and to boost the ECB's existing

[1] Some (e.g. de Grauwe, 2011) have argued that the observed risk premia reflect more market misperceptions than real risk. There might certainly be elements of this, which can be self-reinforcing (both on the upside and the downside as the past has shown). However, while market prices might appear irrational at times, it is difficult to dispute that in some cases high spreads do signal indeed a high risk of default.

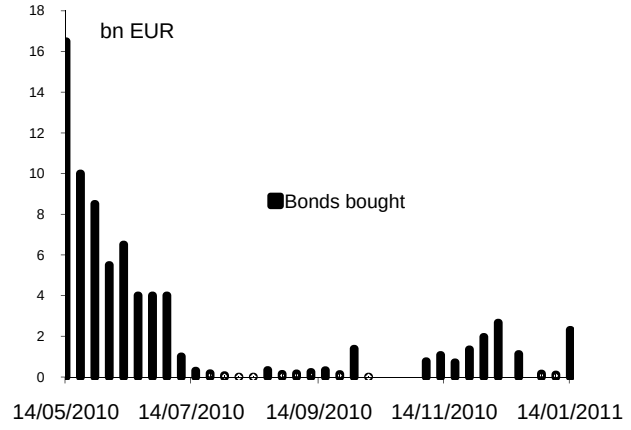
programme for the purchase of EMU sovereign bonds (Securities Market Programme, or SMP). So far, however, the ECB has resisted the pressure to do this (Figure 2). Moreover, it has tried to wean banks in troubled countries off their reliance on its cheap funding via repo operations, but only with limited success given the extreme reliance of banks in both Greece and Ireland on ECB funding (see Table 1).

Figure 1. Yield spreads of euro area sovereign bonds over Bunds



Sources: Haver Analytics, DB Global Markets Research.

Figure 2. ECB purchases of government bonds



Sources: ECB, DB Global Markets Research.

Table 1. ECB net lending to banks in Greece, Ireland, Portugal and Spain, December 2010

	As % GDP	€ billions	As % of domestic deposits
Greece	37%	97.8	27%
Ireland	68%	94.6	31%
Portugal	24%	42.0	13%
Spain	4%	61.6	3%

Sources: AMECO, National central banks and ECB.

In our view, those advocating large-scale purchases of government bonds of troubled countries by the ECB fail to see that the biggest and financially strongest country in EMU resists the fiscal dominance of monetary policy if it has no need to monetise its own government debt. Similarly, it will resist a symmetric fiscal policy, where it has to generate fiscal savings to balance deficits elsewhere. Thus, in a monetary union without political union, the biggest and financially strongest country sets a benchmark for fiscal policy, to which other countries have to adjust (assuming they cannot persuade or force this country to act against its own (perceived and short-term) national interest). It is therefore not surprising that the complaints of those who feel bothered by 'asymmetric policies' are now directed to Berlin instead of Frankfurt, as in the past. Moreover, when monetary policy is run symmetrically and financial bail-outs of weak countries by strong countries are seen as violating the 'limited liability nature' of EMU, over-indebted entities (sovereigns, banks) may default. Hence, a mechanism managing such defaults without creating risks to financial stability is needed.

German policy-makers and the ECB are under heavy pressure to show 'financial solidarity' or to accept fiscal policy dominance of monetary policy. However, to the extent that they accommodate the pressure for fiscal transfers to troubled countries or fiscal policy dominance of monetary policy, the scepticism of the German electorate towards the euro will rise. If the tolerance level of German voters is exceeded, the danger increases that a 'tea party' movement for Germany's exit from EMU would develop. The paradox is that the more policy-makers or the ECB pressure the German voter and taxpayer to stabilise EMU in the near-term by helping over-indebted countries financially or accepting a softening of the euro, the more they damage political support for EMU in Germany.

2. Continuing market tensions and unresolved issues

The creation of the European Financial Stability Facility (EFSF) with its headline figure of €750 billion at a dramatic weekend meeting in May 2010 calmed markets only temporarily. The adjustment programme of the EFSF for Ireland failed to restore market confidence in the EU's ability to deal with countries experiencing financial difficulties. One reason is that the interest rate Ireland was given, close to 6%, is so much above the likely growth rate of the country for the near future that it will worsen its debt dynamics materially. Another reason might be that the lending capacity of the EFSF is de facto constrained by the guarantees of the remaining AAA-rated countries, which amount to about €255 billion.

But more fundamentally, the continuing tensions have in our view been caused more by three developments:

i) The increasing fear that at least one EMU government may be insolvent and hence unable to service its financial debt without help from abroad.

ii) The message from policy-makers that private creditors of an insolvent country will have to suffer losses in the future but that official creditors are not willing to share any losses, as evidenced by the declaration that the claims of the post-2013 'European Stability Mechanism' would be senior to private claims.

iii) The failure of policy-makers to explain how creditors would participate in a debt restructuring of an insolvent country and, in particular, what would happen to presently outstanding debt.

The ECB has provided an element of stability by reluctantly intervening intermittently in the government bond market; officially to restore orderly market conditions, but in reality its interventions have been only of a 'one-way' character, sustaining the price of peripheral government debt. At the same time, however, the ECB has let it be known that in the end it will not let (fiscal) policy-makers off the hook by a wholesale funding of old and new debt of troubled countries via money creation. The ECB was thus not able to resolve the fundamental tensions created by the factors listed above.

The inability to clarify what happens in case an EMU country not only suffers from a temporary liquidity crisis but is unable to repay its debt in the indefinite future has uncovered a major flaw in the architecture of EMU and triggered a flight from all but the safest sovereign bonds of EMU countries. Look at it this way: Passengers will hardly remain calm when the pilot of a four-engine plane announces that he has just lost two engines and offers another round of drinks to passengers as consolation. These passengers will demand that the pilot lands the plane at the nearest airport so that they can get out. By the same token, investors want to know how they will participate in any losses in the not-so-unlikely event that an EMU country defaults on its present outstanding debt. They feel very unsafe when authorities acknowledge the possibility of insolvency three years down the road, but exclude it for the near future, treating every troubled country as if it were only suffering a liquidity shortfall, piling large amounts of new debt on an already-worrisome high level of old debt. Like the passengers of the troubled plane, they want to get out, as soon as possible.

3. What can be done now?

EMU has been compared to the gold standard of the 1920s, where countries had fixed exchange rates (against gold and hence against each other). Some countries (notably the US) accumulated large current account surpluses (and gold reserves), while other countries (notably Germany) ran large current account deficits, which they financed mostly through short-term capital flows. When international capital flows dried up in the wake of the 1929 stock market crash, Germany and other deficit countries struggled to satisfy their borrowing needs. With Germany on the brink of default, the public lost confidence in the banking sector, and in 1931 Creditanstalt in Austria failed following a bank run. The subsequent mass failure of banks led to another downward leg of the depression until 1933. The lesson from the malfunctioning of the gold standard in the 1920s and 1930s is that a system of fixed exchange rates needs an institution capable of managing external imbalances, providing emergency funding when capital markets seize up as well as designing and supervising adjustment programmes aimed at reducing these imbalances.

The architects of the post-WWII US dollar standard had learned this lesson and hence created the International Monetary Fund to manage the system. Unfortunately, the architects of European Monetary Union disregarded this lesson and failed to build the corollary to the IMF, a 'European Monetary Fund', in time. They are now trying to make up for this omission by creating a 'European Stability Mechanism'. But it is extremely difficult to correct a major structural flaw of the system in the midst of a crisis. The IMF was created before the new post-war global monetary system had even started to work.

We argued a year ago that the eurozone needed a 'European Monetary Fund' (Gros & Mayer, 2010). In the meantime, the eurozone has created an emergency funding mechanism, but not yet a 'Fund'. European policy-makers seem to be reluctant to commit to a major institution innovation. We believe that such a step is now urgently needed to put in place a credible mechanism to deal with the existing debt overhang.

Institutional innovations always take some time. However, even within the present setup, an integrated set of measures is possible and should be taken immediately to reduce uncertainty and restore orderly market conditions:

i) All countries under severe financial pressure, for which markets price a high probability of default, should go under the EMU safety umbrella. Most likely, this group would consist of Greece and Ireland, which are already receiving help, as well as Portugal, which is close to being cut off from market funding.

ii) All other countries would have to adopt credible policies for successful adjustment so that they retain access to market funding. Presently, the next country in line suffering from a lack of market confidence is

Spain. Most economists, including the present authors, would regard market fears of an insolvency of Spain as vastly exaggerated. Spain has a relatively low public debt ratio, manageable banking sector problems (confined to the savings and loan segment) and a broadly-based economy with a solid growth potential. Reforms to increase flexibility in the labour market, restructuring in the banking sector and consolidation of finances of regional governments and the pension system would go a long way to reassure investors of the solvency of the public sector. Important steps in the right direction have already been taken on all three fronts, but more could be done. And, more importantly, more needs to be done to restore confidence in the market so that Spain does not face the same problem as Ireland (ever-mounting losses in the banking system).

iii) The EFSF should offer to exchange the outstanding debt of the countries under the safety umbrella against its own obligations at the market price before the countries came under the umbrella.

iv) Once the debt exchange has been completed, the EFSF would negotiate with the debtor a reduction in the nominal value of the debt against an additional adjustment effort. The reduction in debt could be equal to the discount paid by the EFSF, thus implying no direct expense for euro area member countries (but of course they would be taking a risk).

We now turn to a more detailed analysis of the market-based debt reduction scheme proposed here.

4. Market-based debt reduction

The key element of our approach is a market-based debt reduction without formal default. We are aware of the literature on this issue, which concludes that market-based approaches in general are beneficial for both creditors and debtors only when the debtor is in such a difficult situation that a reduction in nominal claims actually increases expected payments (see for example Krugman, 1988). It is difficult to ascertain that this is the case even for Greece today. However, we believe that a market-based debt reduction would still make sense in the particular situation in which the eurozone finds itself at present.

The main justification of preferring a market-based approach is that it would avoid to a large extent the disruption in financial markets caused by a formal sovereign default. The contagion effects would be much more limited as market participants could calculate *ex ante* the maximum risk they incur by lending to other peripheral countries.

How should the exchange be implemented? Given the very low liquidity of most GIP government bond markets,[2] any large bond-buying programme risks distorting market prices. It would thus be preferable to avoid large-scale market interventions and rely instead on a public exchange offering under which the EFSF would offer to exchange GIP government debt for EFSF bonds of the same maturity valuing the GIP bonds at the market value before the country received financial assistance.[3]

For investors who have already marked their holdings to market, an exchange of outstanding GIP bonds against EFSF bonds would be attractive, as they would obtain a safe and liquid asset of the same market value. This would actually increase the access to the repo window of the ECB since the haircut applied to highly rated EFSF bonds would be much lower than the one applied to peripheral bonds.

The ECB should also be encouraged to take advantage of this offer which would allow it to get rid of the portfolio of peripheral debt it had accumulated with its controversial 'Securities Markets Programme' under which it has so far accumulated about €77 billion worth of GIP government bonds. At present market prices (and taking into account interest earned in the meantime), the ECB would probably not have incurred a loss. Once the exchange has taken place, the ECB would not have any reason to resume buying GIP (or other) government bonds.However, the real problems arise from the large amounts of peripheral debt held by other institutional investors, especially banks and insurance companies, which have the assets still at purchase or nominal value in their books. These institutions need to be induced by their supervisory authorities to write down their holdings to the guarantee price so that they would eventually also be in a position to exchange their bonds. Some banks might be interested anyway in getting rid of their holdings of peripheral debt with limited losses and without having to sell them on a very thin market because a balance sheet without any remaining exposure to the periphery would strengthen their own position in the market and lower funding costs. However, other banks and some insurance companies might not be in a position to do so because they do not have enough capital to bear the losses. In these

[2] For example, the trading in Greek government bonds on the main Greek exchanges has collapsed to less than €10 million daily (December 2010), compared to about half a billion one year earlier. See http://www.bankofgreece.gr/Pages/en/Bank/News/PressReleases/DispItem.aspx?Item_ID=3520&List_ID=1af869f3-57fb-4de6-b9ae-bdfd83c66c95&Filter_by=DT

[3] One could argue that a further advantage of going through an exchange offer (instead of buying on the market) is that the EFSF would not have to issue additional paper on the primary market. We consider this a marginal aspect since the recipients of the EFSF paper will certainly either trade it on the market or use for ECB repo operations.

cases the pressure of the supervisors needs to be stronger because the key point to stabilise the euro area's banking system is to deal with its weaker elements.

It will thus be crucial that especially the weaker banks are induced to write down and then exchange their holdings of debt of countries with an EFSF programme. Any capital shortfall would have to be made up quickly by either raising capital in the markets or by an infusion of public funds. This is exactly what was supposed to be done in the context of the ongoing stress tests.

Designers of stress tests face a dilemma: they have so far refrained from testing the stress that markets are really worried about, namely a sovereign default. The current banking regulation is based on the assumption that all euro area government debt is riskless. This has two implications: banks do not have to hold any capital against their holdings of government debt and public debt that is held in the banking book (which assumes that it is held to maturity) is always valued at face value (whatever its market value). The first EU-wide stress test in the summer of 2010 showed, not surprisingly, that close to 90% of all government debt held by banks is in the banking book and thus not subject to mark to market. Thus, the first stress test could not provide a clear answer to the key question: Which banks would not be able to survive the default of one or more euro area governments?

In 2010, regulators argued that they could not officially test the resilience of the EU's banking system to a sovereign insolvency because they would then have to include in their stress scenario an event that was officially not on the agenda. Moreover, the official argument was that the Greek adjustment programme had just started and there was no reason to doubt that it would succeed. It would have been considered illogical for governments first to put together a €110 billion package for Greece and then assume a few months later in a stress test that Greece goes bankrupt.

All these arguments misunderstand the purpose of stress tests and the concerns in the market: namely the question of what would happen if the official plan does not work. The deeper problem of the present situation in which official institutions cannot even think about the consequences of a default is that it becomes impossible to develop a 'plan B' until 'plan A' has completely and visibly failed. But then it might be too late.

5. Numbers: Discount, exposure and funding requirements?

Discount. Assuming an average maturity of bonds of the GIP countries of roughly five to seven years, an average coupon of 4.5% and a yield to maturity of 8%, the average implied haircut priced by the market would seem to be between 20-25% (somewhat higher for Greece, but lower for Portugal). Thus, investors would have to write off about €130 to €160 billion of the aggregate debt of the GIP countries, while the EFSF would have to acquire an exposure of some €490 to €520 billion (the total public debt of the GIP outstanding in nominal terms amounts to about €650 billion).

This is a large, but not intolerable risk burden for the EMU countries. Assuming as a worst case that the fundamental value of GIP debt is only 60% of GIP GDP (or around €340 billion), the maximum loss EMU countries could suffer would be around €180 billion. Taking this risk would undoubtedly be painful, but, at an exposure of little more than 1.5% of EMU GDP, it should be considered an acceptable price to pay for the stabilisation of the euro (or rather its financial markets).

Bank debt. This calculation is based only on the presently outstanding public debt of the three GIP countries. Once a country enters a crisis, one has to add bank debt to public debt. One could thus argue that the cost of bank recapitalisation would have to be added to the sum mentioned so far. The Greek and Irish programmes already allow for this. However, when bank debt becomes public debt, the assets of the banks also become public assets. Whether or not bank rescues increase public debt is thus essentially a question of the quality of the assets on the books of the banking system. This is a key point for Spain and Ireland, whose experience has shown that asset quality can deteriorate quickly (or simply be misjudged at the outset). This is why we recommend a large programme of asset sales for Ireland and Spain to reassure investors on this point (discussed in more detailed below).[4]

External debt. In estimating the risk that euro area member countries take as creditors of the post-exchange public sector liabilities of the GIP countries, one should not look only at the public debt of these countries, because the ability of these countries to service their obligations to other euro area countries is a question of their ability (and willingness) to transfer

[4] The governments and banks in distress often retain the hope that the true value of their assets is much higher and resist asset sales with the argument that a 'fire sale' does not allow them to realise this 'true', long term value. ,It will be very important, however, to allow as many as possible potential foreign investors to undertake a due diligence of these assets so that they can form their own opinion. The market will trust the results of such a process much more than the ever-changing numbers that regulators and accountants put into the balance sheets of the troubled banks in Ireland and Spain.

real resources to foreign residents. Public debt that is owed to domestic residents can in principle always be served because it represents just a transfer within society, and could be financed for example through a capital levy on deposits or other tangible assets (of residents). In reality, as can be seen from Table 2, only for Greece and Portugal does our preferred measure of foreign debt (the cumulated current account) exceed 60% of GDP.

Table 2. External and government debt (% of GDP)

Panel a	**Net international investment position (2009)**	**Net external debt from cumulated current account**	**Government debt 2010**
Greece	-88	108	141
Ireland	-102	19	97
Portugal	-113	105	83
Spain	-96	59	64
Italy	-20	9	119

Panel b	**Ratio of (net) external debt to government debt**
Greece	0.8
Ireland	0.2
Portugal	1.3
Spain	0.9
Italy	0.1

Note: Net external debt is computed as the sum of current account balances over the period 1990-2010.

Sources: Commission Services (Ameco database) and IMF International Financial Statistics.

The key point is thus that for some countries external sustainability should not be a problem, even if their public debt is very large. For Greece net foreign debt is approximately equal to four-fifths of the net public debt of the country (see Panel b of Table 2).[5] For Portugal foreign debt is about 30% higher than public debt. But for Ireland most of the debt is domestic since the foreign debt of the country is only one-fifth of the public debt. This implies that the rough calculation made above of the risk taken by euro area countries as creditors of the post-exchange public debt of the three GIP countries represents, if anything, an upper bound of the risk taken by the EFSF.

Funding requirements. Financing this debt exchange would require an increase in the size of the EFSF, although in principle the headline funding of the €440 billion EFSF, plus the EFSM of €60 billion plus the €60 billion already earmarked for bilateral credits to Greece would be sufficient to cover all three GIP countries (i.e. sufficient to acquire 100% of the outstanding public debt at the average discount mentioned above). In reality somewhat less might be needed as some investors will not want to sell their holdings of GIP debt because their own evaluation of the repayment probabilities is different from that of the market average today. In the banking sector only the most strongly capitalised institutions would be allowed to pursue this gamble.[6]

Another avenue to ensure that banks do participate in the exchange offer is for the ECB to return to its pre-crisis rules on collateral and stop accepting lowly rated bonds as collateral. If the old bonds can no longer be used for repo operations at the ECB, most banks would have a strong incentive to tender their holdings for the exchange. It is possible, but not certain that ratings agencies would classify the debt of the countries in question as 'selective default'. Under current rules, this would oblige the ECBto decline to accept this debt henceforth for its monetary policy operations.

Once the EFSF has acquired most of the outstanding GIP debt, it would start negotiations on debt relief with these countries. The EFSF would offer to write down the nominal value of its claims to a level consistent with the price it had paid for the bonds. As a counterpart for this debt relief, the countries concerned would have to undertake an additional adjustment effort whose details would of course have to be negotiated in detail. The EFSF could thus deliver to the country (conditional on the implementation of the additional adjustment programme) the bonds it bought on the market against new bonds of the country concerned. These new bonds should have a long maturity, ideally at least 10 years or more with an interest rate equal to the refinancing cost of the EFSF plus a moderate servicing charge.[7]

[5] There are many ways to measure net foreign debt. We prefer to look at the cumulated current account position and the international investment position of the country.

[6] Investors holding out will be aware that default becomes more likely the more systemically important investors have been paid out. Hence, the lower the remaining outstanding debt in the market, the higher is the likelihood of default on this residual debt. This should provide an additional incentive for investors to accept the exchange.

[7] It is actually not that straightforward to determine the refinancing cost of the EFSF. At present the EFSF has issued only a very limited amount of bonds, which trade about 50 to 60 basis points above German government bonds of similar maturity. But in the exchange proposed here, the EFSF would not need to go to the market as it just exchanges its bonds against the distressed debt. Arguably the cost of the EFS would be the interest rate it offers to pay on its own bonds. This interest rate might well be considerably lower than the market yield on the small

It is of course possible that the market discount is not enough to ensure sustainability (under realistic assumption about growth). The EFSF might agree on a lower interest rate and/or even longer maturities. But, to offset this subsidy, the EFSF should insist on a call option for additional payments by the country in case GDP growth exceeds a certain threshold (GDP warrants).[8] This would make sense in a longer-term perspective since for over indebted countries only a return to growth can make the debt sustainable. The experience with the Irish adjustment programme has shown that it is politically very divisive for the EU if an official institution were to insist on punitive interest rates from a country whose economy remains in depression for a long time. All the official adjustment programmes foresee a return to healthy growth within a couple of years. It would thus make sense for an official institution like the EFSF to express its confidence in the very programmes it finances.

A key condition for our approach to work of course is that the debt level after the exchange is sustainable. We believe that this would be the case even for Greece, the most heavily indebted country. Many observers casually assert that solvency can be re-established in Greece only if debt is cut by at least half. We disagree. Experience shows that often even a relatively small reduction in debt can lead to a restoration of market access at favourable rates. For example in the case of Mexico, in the 1980s, a 'hair cut' of 35% turned the situation around. Technically speaking, the relationship between the risk premium and debt levels is highly non-linear. Beyond a certain threshold, higher debt leads quickly to higher risk premia. It is the combination of the two that can render the debt service unbearable. The Annex provides some illustrative calculations, which show that sustainability could be restored even for Greece through a combination of debt relief of the proportion calculated above with a stable low interest rate.[9]

One cannot expect that the (conditional) debt relief offered by the EFSF will re-establish immediately full market access. But the funding requirements of the GIP countries would be much reduced because their deficits would be even lower than the baseline assumed in the existing programmes and the refinancing needs of debt coming due much reduced. These limited and hopefully temporary financing needs could be borne by the IMF programmes which already today form part of the financing packages for Greece and Ireland (most of which remains unspent so far). The IMF could thus continue to fulfil its normal role, and its non-European members would be more likely to support the relatively large programmes for the GIP countries given that the debt exchange will have improved the sustainability of their finances. The combination of debt exchange, reduced deficits and available IMF funding would effectively mean that the GIP countries would not need to go to the markets for the next few years.

6. Seniority: The public sector must be consistent

The ultimate aim of any debt reduction scheme is to allow the debtor to regain access to capital markets. Given that the GIP countries will still have a high public debt after any market-based reduction, this will be possible only if the euro-area partner countries are willing to take on some risk.

Immediately after the debt exchange, the EFSF would hold most of the GIP public bonds. Since it acquired these bonds at market prices it would not constitute a senior creditor, nor should it pretend to be one. This implies that at this point the debt exchange should not have negative impact on remaining private creditors.

However, once the EFSF has negotiated (and implemented) a debt reduction, it would become a direct creditor of the GIP countries and could pretend seniority status given the nature of its lending and maybe given its supranational status (de facto, of course but so far not de jure).[10] But this should not be done because it would make it very difficult for the GIP countries to return to capital markets.

outstanding amount of EFSF bonds since one could argue that the current yield on EFSF bonds is not the best benchmark given their limited liquidity and given that the EFSF is still a new issuer.

[8] Gros (2010a) provides some illustrative calculations for the value of GDP warrants under which (for example) the government of Greece would offer to allocate a certain percentage of any increment in nominal GDP (after the trough expected for 2010-11) to additional payments to foreign creditors, pro rata their present holdings. If Greece were to pay to foreign creditors about 4-5% of any increment in nominal GDP substantial payments could built up over time, with full (even if late) payment likely of the post-exchange debt, if Greece returns to a decent growth path. See also Borenzstein & Mauro (2002).

[9] For an indication of what might be realistic, see Alcidi & Gros (2010), which provides an account of the European experience with large fiscal adjustments.

[10] The senior status of supranational lending (especially for the IMF) is more a widely accepted practice than a legal principle. In reality member countries can exert much more pressure on a defaulting country than private creditors can. What is thus needed is more a political signal that the creditor countries are willing to take a risk, rather than a legal text.

At an earlier stage of the crisis – in April/May of 2010 – member states explicitly made an important choice, but one not widely noted at the time, by requiring neither their bilateral loans to Greece, nor the EFSF credits, to be senior to other, private-sector claims. Germany thus had explicitly accepted at that time that it might make losses in the event that Greece, or any recipient of EFSF support, could not service its debt. This changed with the statement of the Euro group of 29 November 2010, which stated explicitly that loans from the future crisis resolution mechanism (ESM) would have a standing senior to private creditors (and only subordinate to the IMF). Moreover, the Euro group also announced at that time that the Greek package and the existing EFSF package(s) would be rolled into the new permanent mechanism. In practice this means that if Greece were to have to restructure its debt once the new mechanism comes into force (presumably by 2013), the official creditors would be repaid first and the losses would mainly have to be borne by the private creditors.

Finance ministers are the ultimate insiders. If they decide that they need to protect their own lending via a seniority clause, they are sending a clear signal to financial markets: buyers (without seniority) beware; we have doubts the country can fully service its debt! It should thus be no surprise that risk premier shot up in response.

As long as official creditors insist on making their 'liquidity' assistance safe by making it senior to private claims, they are making private claims junior. This implies that more official financing can only make private claims more junior (and thus private financing more costly). After all a country has on the asset side of its balance sheet a (limited) capacity to service debt. Changing the composition of the liability side by making some claims senior to others will not change the market value of their total. The conclusion is clear: If official credits are made senior, the average cost of debt for the debtor country concerned does not fall when it receives official financing (assuming official financing has a lower cost) since there will be a corresponding increase in the cost of private funding.[11]

These considerations apply especially in the case of Greece where one would expect that even after the debt exchange the debt ratio would remain 120% of GDP. For example if bonds with a nominal value of around €240 billion were exchanged at an average discount of 25% the reduction in the nominal value of the debt the scheme could achieve would be €60 billion, or a little less than 30% of the Greek GDP (now around €220 billion, but shrinking). With a debt/GDP ratio around 150% today, this would imply that this ratio would fall after the debt exchange to around 120% of GDP. This is still a value that might leave some room for doubts about the solvency of the Greek government given its poor track record in raising revenues.

As argued above, the official stance needs to be consistent. An adjustment programme that is supposed to re-establish debt sustainability cannot be credible if its main promoters (in reality, the creditor member states) express their own scepticism about the success of the programme by requiring punitive interest rates and making their claims senior.

If the EFSF (or its successor institution) does not pretend to have more rights than a normal private investor, it will also become easier for the countries to raise funds on the capital market to pre-pay the EFSF should their economic conditions improve more than expected.

7. Asset sales to deleverage the sovereign

We have assumed throughout that the case of Spain is different in the sense that public debt is still relatively low (around 60% of GDP, albeit rising quickly) and that the losses in its banking sector should be manageable. However, this view is clearly not shared by enough market participants, as evidenced by the risk premia the Spanish government has to pay, and the difficulties many Spanish banks are facing in refinancing themselves on the market.

In Spain the weakest part of the banking system are the local savings and loans (called *cajas*), which have financed mostly residential mortgages and local property developers. Most of the *cajas* are thus in trouble. Simply aggregating the weaker institutions into a small number of bigger ones does not really address the underlying problem. On the contrary it might make it even more difficult to deal with. The savings that could be achieved by consolidation are minor: the total personnel cost of all the *cajas* together amounts to around €9 billion per annum. Even assuming that 20% of this could be saved by consolidation would imply savings of less than €2 billion per annum, which is a magnitude smaller than even the margin of uncertainty concerning the value of the over €900 billion in assets on the books of these institutions. Moreover, firing costs are known to be rather high in Spain. Any reduction in personnel would thus in the short run require additional funding of severance pay.

Aggregating a number of weak smaller institutions into bigger ones makes it ever more difficult to have any private sector contribution to the losses because the larger institutions, created essentially under government orders, become automatically 'too big'

[11] See also Gros (2010b).

and 'too politically sensitive' to fail. By not letting any of the smaller and weaker of the *cajas* fail, the Spanish government is increasing the risk for itself.

This gamble might pay off if the value of the loans on the books of the *cajas* is really as high as assumed by the accountants of the *cajas* and the regulators. However, the still rather comforting valuations of the loan book of the *cajas* (and the other Spanish banks) are underpinned mainly by the still relatively low losses rates in Spain so far and the tendency by accountants and regulators to look only at the losses for this year and at most those expected one year ahead. But this is misleading since the Spanish property bust will likely last the better part of this decade. The experience of Ireland has shown that losses can escalate rapidly as the property bust deepens. In this respect it seems that the worst is still to come in Spain where house prices have fallen relatively little (less than 15%) from their peak which according to many estimates was perhaps 100% above the longer-run equilibrium. Moreover, the experience of the US has shown that during a property bust house prices might actually undershoot the long-run equilibrium, especially when there has been overbuilding on such a vast scale as in Ireland and Spain.

The only way to eliminate this uncertainty about the size of the eventual losses would be a disposal of the doubtful (perhaps the qualification 'toxic' would be appropriate under current circumstances) assets. In Spain this could take several forms. For example, a sale of the *cajas* to foreign institutions (either investors with deep pockets or very well capitalised foreign banks) would give the market a guarantee that Spain will not become a second Ireland, i.e. that the liabilities of the Spanish sovereign are limited. A further consolidation of the Spanish banking sector by a takeover of the *cajas* by some of the large Spanish banks would not solve the problem of the potential for large implicit liabilities for the Spanish government.

Another way to limit the potential for losses for the Spanish government would be asset sales in the narrow sense: the regulators could force the *cajas* that have already been taken over to sell part of their loan book, again preferably to foreign investors. This might be politically easier and quicker given that even the transformation of the legal structure of the *cajas* into limited liability companies might take some time.

In either case the prices at which loan books can be sold will give a clear and market-based signal of the losses that investors expect still to come. This applies *a forteriori* also to the case of Ireland. It is no longer possible to sell any of the Irish banks. But their loan book is still on their books at the equivalent of over two times national income. If this is their true value, the Irish government would not have any further losses to bear and should be able to service the debt it has incurred so far. However, as long as doubts persist that the value of these loans is in reality much lower, the Irish government will not be able to access capital markets.

The Irish and Spanish governments have *de facto* leveraged themselves very highly due to the explicit (Ireland) and implicit (so far Spain) guarantees they have given to their banks. These guarantees are off balance sheet and thus do not appear explicitly as public debt, but the bond markets see through this fiction and aggregate public and bank debt and require a hefty risk premium. The best way to reduce this risk premium would be large-scale asset sales. Here again the authorities should be consistent and should be confident that the market will validate their point of view once given a chance to look at all the details that an investor will undoubtedly require in a due diligence process.[12]

8. Concluding remarks

The piecemeal approach to dealing with the euro area's sovereign debt crisis (instead of a comprehensive solution along the lines sketched above) runs the risk of cutting off one country after another from market funding. It has been suggested that the EFSF be increased to cover all potential problem countries. But simply increasing the size of the EFSF may raise market fears of a financial over-burdening of the core countries and hence extend the crisis of trust eventually to all EMU member countries. It has also been suggested that the ECB step up its bond purchase programme and acquire EUR1-2trn of bonds of troubled EMU countries. In our view, however, this, as well as the suggestion to assume joint liability for EMU countries' entire debt, would undermine the contractual basis of EMU and seriously weaken acceptance of EMU in the core countries.

We have outlined a market-based scheme to achieve a substantial reduction in debt for the most distressed sovereign borrowers. This scheme could serve as a bridge from the present situation under which a combination of a weak banking system and acute insolvency problems creates tensions that require ever more public funds.

The debt exchange offer we recommend does not constitute a silver bullet that will solve all issues. To work it will require an intensification of the adjustment efforts in all countries and an aggressive programme of asset disposal in Ireland and Spain to ensure the solvency of the sovereign in both countries.

[12] The same course of action might be useful for Portuguese banks, which are becoming the Achilles heel for the country.

Moreover, the EU (or rather the EFSF) must be consistent in its actions and express its confidence in the solvency of the peripheral countries (after the debt reduction) by providing them with the equivalent of equity, rather than senior debt. As long as official creditors pretend to be senior to private ones, these countries will not be able to return to the market.

Having dealt with the emergency, a new EMU architecture can then be constructed that enshrines the lessons learnt from the current crisis. What is needed in our view is a further step towards economic integration combined with some risk-sharing of EMU countries while still preserving the character of EMU as a 'limited liability company'.

In this longer-term perspective, we regard our proposal as a key step to establishing the principle that losses on sovereign lending are possible. It is extremely important that markets and regulators actually have the experience of suffering some loss as this is the only way to ensure more market discipline (however imperfect it may be) in the future and a regulatory framework that abandons the concept that sovereign lending is riskless. The present situation is untenable as it contains an inherent contradiction between the insistence on the legal fiction that there will never be a bail-out and the repeated cave-ins by the authorities at the first sign of serious market pressure.

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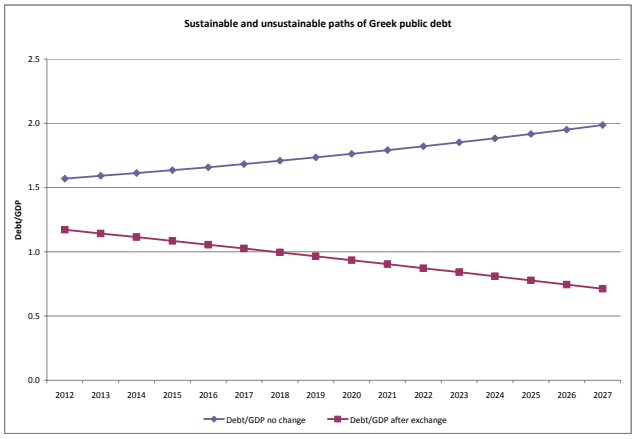
Annex

With the use of a numerical example calibrated to the case of Greece, this annex is intended to illustrate the impact a combination of moderate debt relief and lower interest rates can have on sustainability. To set a very undemanding benchmark, we assume that Greece will be able to maintain a primary surplus of only 4% of GDP. This is much lower than what other EU countries achieved during other periods of budgetary consolidation (often in the vicinity of 5-6% of GDP). We also assume that the trend growth rate of nominal GDP will be only 3%. This is clearly an extremely conservative assumption. Over the next few years, the Greek economy is indeed likely to stagnate and for some time wages and prices will have to increase less than elsewhere in order to re-establish competitiveness. But this should not last forever, as implicitly assumed in our calculations. As to the interest rate, we assume that without the debt exchange, the Greek government would be lucky if it could refinance itself at 7%, whereas the EFSF could offer around 4% as argued above. We then calculated the path for the debt-to-GDP ratio with and without the debt exchange as proposed by us assuming that the debt exchange yields a reduction in debt of only around 22%, reducing public debt from the 155% of GDP to be expected in 2012 to about 120%. The chart below shows clearly that the debt exchange (combined with EFSF financing) would put the country on a stable path, whereas that would not be the case if there were no cut in debt.



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