No Pause in Greek Debt Drama

Robert McMahon, Council for Foreign Relations, June 30, 2011

The embattled Greek government has survived a vote of no confidence in parliament and won back-to-back votes approving its tough $40 billion austerity plan (*WSJ*) in the same chamber. These mark major steps toward receiving a $17 billion package of emergency loans by the middle of July and avoiding what would be the eurozone's first sovereign default. Details on a larger international bailout to provide financing through 2014 could come this weekend in a meeting of eurozone ministers.

The news from June 29-30 was treated with relief in U.S. and European markets, which fear the impact a Greek default would have on countries and financial institutions heavily invested in Greek debt. A default could severely affect other weak economies on the eurozone periphery, including Ireland and Portugal, which have also received international bailouts, and potentially threaten the viability of the seventeen-nation eurozone. There is exposure in the United States as well. For instance, millions of Americans hold money market funds, which have loaned money to European banks that have loans to Greece (Bloomberg). And though a number of analysts say threats to money market funds (*CSMonitor*) are overblown, others cite the 2008 collapse of U.S. firm Lehman Brothers, which contributed to a freeze in interbank lending, upheaval in markets, and showed even money market funds were not risk-free. "If other countries are drawn in [to the Greek debt crisis] through contagion, it could be bigger than Lehman" (Reuters), Josef Ackermann, the chief of Deutsche Bank, said on the eve of the Greek parliament vote.

While the vote was welcomed in financial venues, the air of crisis has not lifted in Europe. The options for a sustainable path forward for Greece to wind down its massive debt appear slim. Some experts believe Greece will still have to default. Two analysts from Commerzbank said concerns would persist (*NYT*) "if no broader consensus across Greek political parties forms" on economic reforms.

A big reason for general unease is the scale of Greece's problems. Its debt is estimated around $480 billion, close to 150 percent of GDP. As a Bloomberg editorial notes, even in the event of a second bailout and economic recovery for Greece, the government would have to run a budget surplus "of 5 percent of GDP for about three decades to bring down debt to the 60 percent [of GDP] maximum allowed by euro-area rules"--an extremely rare feat. CFR's Sebastian Mallaby cites the complications posed by Greece's large current-account deficit and the fact that Athens compiles more debt from foreigners as long as this deficit persists. To stop running such a deficit, he writes, "Greece must become more competitive. Since exchange-rate adjustment is impossible for a country with the euro, the depreciation has to come in the form of falling wages and prices. That is not only politically implausible. It would also boost the real value of Greece's debt and compound the core problem."

What to do? Writing in the *Financial Times*, analyst Jean Pisani-Ferry cites "only two economically consistent options." (voir ci-dessous) Plan A, he writes, "is to socialize the Greek debt. It requires lowering the interest rate on official assistance to a level that makes Greece solvent and deciding who, if needed, will bear the corresponding cost--either the banks, through a special levy or, by default, the ordinary taxpayers. Plan B is to make private creditors pay through an orderly restructuring."

Meanwhile, a French proposal gaining attention has private bondholders reinvesting half of the proceeds of maturing Greek debt in new thirty-year bonds. The plan encourages private-sector participation (*DerSpiegel*) and provides government backing in the event of a Greek default. German officials have said it could provide a basis for discussions on the second Greek bailout package, but a number of analysts quoted by the *Wall Street Journal* said the conditions only add further burdens for Greece and simply delay its day of reckoning.

Selected Analysis:

The Greek crisis is relevant for other European nations with high debt-to-GDP ratios--like Italy, Belgium, and Spain--and it highlights problems with Europe's "less-than-healthy banking system," writes Heather Conley, a senior fellow at the Center for Strategic and International Studies.

EU bailout funds should be expanded and given powers to buy bonds in financial markets, which would "send a much-needed signal that member countries 'will do whatever it takes to safeguard the stability of the euro area'," the IMF says in a new report on the eurozone.

Five tasks for Europe's leaders
Jean Pisani-Ferry, blog *Financial Times*, June 28, 2011

At their meeting last week, European leaders agreed again to "do whatever is necessary to ensure the financial stability of the euro area as a whole". But they did not say how. Even if Wednesday's vote in Greece's parliament averts an immediate crisis, they would be well advised to make use of the long European summer season to turn this unspecified commitment into an action plan. Here are some modest suggestions for their holiday homework:

1. Complete the banking sector clean-up. Financial fragility is heightened by the still-unfinished recapitalisation of the weaker banks. Two years after the US successfully completed its stress tests, Europe is still struggling. The publication of new tests, expected in July, offers a chance to aggressively restore the soundness of banks across Europe. This may cost public money and political capital, but no political expediency can justify missing the opportunity.

2. Explore options to address insolvency. Last week, the German proposal for a compulsory rescheduling of Greek debt was rejected. But to pretend that an insolvent country will repay its debt is no strategy. There are only two economically consistent options. One, call it Plan A, is to socialise the Greek debt. It requires lowering the interest rate on official assistance to a level that makes Greece solvent and deciding who, if needed, will bear the corresponding cost – either the banks, through a special levy or, by default, the ordinary taxpayers. Plan B is to make private creditors pay through an orderly restructuring. To make it a viable option, preparations must be undertaken, not least by the ECB, so that when restructuring takes place its financial fallout can be contained. Each plan is anathema to some of the leaders, but one will eventually have to be chosen. The Europeans should make use of the time they have bought to evaluate their implications and choose a strategy.

3. Make better use of the crisis management facility. The recently created European Financial Stability Facility (EFSF) and its successor the European Stability Mechanism (ESM) are potentially powerful instruments to preserve financial stability. But lack of trust and domestic politics have led to attaching too many strings to their use. As they stand they can neither serve to prevent a crisis through precautionary lending nor to resolve it by serving as a backstop to debt restructuring. This is a waste of scarce resources. The EFSF/ESM should be turned into a more flexible instrument to help preserve financial stability.

4. Devise an adjustment and growth strategy for southern Europe. Fiscal consolidation is of paramount importance but ultimately, what will matter most is whether southern Europe can return to growth. So far the joint European Union and International Monetary Fund programmes have, with some success, focused on the fiscal front. But unlike Ireland, southern Europe has not started reducing the real exchange rate misalignment resulting from a decade of excessive inflation, and growth prospects remain remote. The EU should now move on this front. A first and simple step should be to make better use of the money it spends in Greece and Portugal. Both countries are major beneficiaries of structural transfers, but EU money is both under-spent and badly spent (because guidelines set long ago are at odds with current priorities). The EU should pass special legislation to speed up the disbursement of aid and, as long as assistance programmes are in place, allocate it to supporting their growth component.

5. Address the underlying weaknesses of the euro area. Euro area surveillance reform, about to be completed, will help diminish the risk of future crises. But nothing has been done to remedy the lethal correlation of banking and sovereign crises. Sovereigns should be better protected against the failure of their banks, through the centralisation of supervision and the creation of an insurance scheme akin to the US Federal Deposit Insurance Corporation. By the same token banks should be better protected against the failure of their sovereigns, through diversification of their bond portfolio. Today, any meaningful restructuring of the Greek debt would wipe out the capital of the Greek banks. As long as this concentration of risk persists, sovereign restructuring will remain more dangerous that it needs to be. This is the most potent justification for introducing Eurobonds, because they would offer a natural diversification instrument.

Throughout the crisis the European leaders have consistently demonstrated a strong commitment to the euro. But as Winston Churchill once said of the US, they can be trusted to do the right thing only after having exhausted all other possibilities. This behaviour is too costly to be sustained. The leaders should now move ahead of the curve and take initiatives.

The writer is a French economist and director of Bruegel, a Brussels-based think-tank focusing on global economic policy-making.