# To end the Eurozone crisis, bury the debt forever

**Pierre Pâris, Charles Wyplosz, *vox*, 6 August 2013**

Voir aussi PADRE *Politically Acceptable Debt Restructuring in the Eurozone*
Geneva Reports on the World Economy Special Report 3

The Eurozone's debt crisis is getting worse despite appearances to the contrary. How can we end it? This column presents five major options for reducing crisis countries' debt. Looking into the details, it seems the only option that is both realistic and effective is for countries to default by selling monetised debt to the ECB.

The Eurozone's debt crisis is getting worse despite appearances to the contrary.

Eurozone bond rate spreads have narrowed – leading some to think that the crisis is fading.[1] Yet the narrowing is not due to an improvement in fundamentals. It happened after the ECB announced its Outright Monetary Transactions (OMT) programme. Mario Draghi's, "Whatever it takes", did the trick; investors believe the ECB could and would counter rising spreads in the medium term.[2]

But this means that the information in the spreads is muddled:

- Spreads no longer show us what investors think about debt sustainability.
- They reflect a mix of debt-sustainability expectations and forecasts of ECB reactions.

This is yet another instance of Goodhart's Law – a variable that becomes a policy target soon loses its reliability as an objective indicator (Goodhart 1975).

**How to gauge the Eurozone debt crisis**

This leaves us with a coarser measure – the evolution of public debts – as a ratio to GDP. Spreads were clearly better indicators before OMT. There are plenty of problems with debt-to-GDP ratios:

- Gross debts are gross, i.e. they ignore public assets.
- Gross debts ignore unfunded public liabilities such as pensions and healthcare.

In most countries the unfunded liabilities – which include the potential costs of bailing out banks when and if they fail – are vastly bigger than the public assets that can be disposed of.

- GDP is a static measure of the ability to pay; GDP growth also matters.[3]

Noting that Eurozone growth seems to have slipped into a go-slow phase, the GDP denominator is likely to grow slower than it did in the 1990s.

The three points taken together suggest that debt-to-GDP ratios of the 2010s paint a more optimistic picture of sustainability than the same levels in the 1990s.

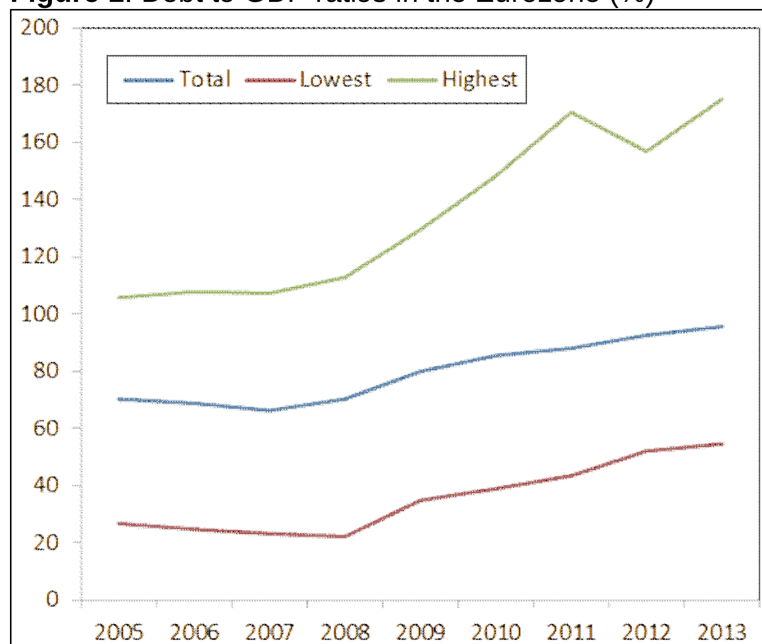
Be that as it may, Figure 1 displays the public debt to GDP ratio for the Eurozone as a whole, along with the highest and lowest member country ratios (ignoring the two special cases of Estonia and Luxembourg).

- Even including optimistic forecasts for 2013, the figure can only confirm that the situation is getting worse.

If public debt seemed likely to be unsustainable in 2008, the likelihood is even higher now. Strikingly, this holds even for Greece, in spite of the restructuring of its public debt in 2011, which was large enough to bankrupt the Cypriot banking system. Put differently, not only the initial problem has not been solved, it has also been made worse.

There can be no surprise here. Budget stabilisation cannot work during a recession as was pointed out at the outset of crisis (Giavazzi 2010, Wyplosz 2010).

**Figure 1**. Debt to GDP ratios in the Eurozone (%)




*Source*: AMECO-on-line, European Commission.

**What are the options today?**

The debt problem cannot be avoided or hoped away. When debt is unsustainable it will not be sustained. The only question is how and when the crisis comes. Here are the five options that can address the debt quagmire.

**Option 1: Long-term debt reduction through budget surpluses**

A key mistake of the Troika was to impose immediate fiscal retrenchment without articulating any long-term vision. It is well known (Buiter 1985) that it takes decades, not years, to use budget consolidation to reduce public debts once they have been allowed to rise to extremely high levels. If the Maastricht criterion of 60% is taken to represent a reasonable level – no one knows what is reasonable, but this is a side issue here – some countries such as Greece, Portugal, and Italy will probably need some 20 years or more to reach this level.

Moving from a deficit to a surplus is contractionary but remaining in surplus afterwards is not. This is why the costs of debt reduction are front-loaded and also why this is not the time to undertake these policies.

Of course, the longer it takes to start the process, the larger the debt and therefore the longer the debt retrenchment period afterwards. The resumption of growth is therefore a crucial precondition.

This would be the most desirable course of action if fiscal policy could be made temporarily expansionary, or if monetary policy could be used to kick-start the recovery, or if exports could lift the economy. Structural reforms are sometimes offered as an alternative but these policies take many years to produce their effects and are often contractionary at the outset.

**Option 2: Sales of public assets**

It would seem natural and easier for governments with large gross public debts to sell parts of their assets and use the proceeds to buy back bonds. This would reduce their exposure to volatile market sentiments and, ignoring implicit liabilities, hopefully demonstrate that their debt position is actually sustainable.

The problem is that we know little about the values of government assets. The OECD produces estimates of net debts, which can be used to recover estimates of assets

(computed as gross less net public debts). The resulting estimates are shown in Table 1. For the Eurozone as a whole, government assets would amount to some 3% of GDP and most country estimates are found in the 30-45% range. Asset sales could bring indeed many gross debts down by significant amounts.

Whether that would be enough to remove the spectrum of defaults is impossible to assess.

**Table 1**. Estimated general government assets (% of GDP)

| | |
|---|---|
| Austria | 34.6 |
| Belgium | 21.7 |
| Finland | 117.0 |
| France | 39.6 |
| Germany | 37.6 |
| Greece | 61.9 |
| Ireland | 44.0 |
| Italy | 27.3 |
| Netherlands | 38.9 |
| Portugal | 45.1 |
| Slovak Republic | 31.7 |
| Slovenia | 52.8 |
| Spain | 29.3 |
| Euro area | 37.4 |

*Source*: Economic Outlook, OECD, June 2013.

Unfortunately, disposing of all government assets is neither possible nor desirable. In order to achieve its aims, a disposal of assets would have to be achieved in relatively short order, say two or three years. This would represent a massive administrative effort, probably beyond reach. It is also not desirable because it would resemble a fire sale.

**Option 3: Classic debt restructuring**

Under current conditions, the first two options are most likely to be unreachable, at least soon enough to avoid a continuation of the downward spiral that has gripped nearly all of the Eurozone. Rising public indebtedness naturally leads to a new phase of acute crisis. This will make debt restructuring not just unavoidable, but attractive.

The problem is that each country's public debt has migrated to the books of its commercial banks. A debt restructuring deep enough to bring the debt to 60% of GDP is bound to trigger a bank crisis, which would require government intervention and more debt.

The much-maligned link between public debts and bank assets has become worse, enough maybe to make sovereign debt restructuring unmanageable without outside help.

Critically, many governments will need resources for bank recapitalisation following debt restructuring.

But the problem with bailouts is that they are no longer available in adequate quantity.

The main potential pool of money is the European Stability Mechanism, which is due to eventually reach a firepower of €500 billion. Compare this with the total debt of the crisis countries – Greece, Ireland, Portugal, Italy and Spain – which amounts to some €3750 billion. Add France, a likely candidate for crisis, and you reach €4710 billion. It is pretty clear that the resources of the European Stability Mechanism are nowhere near big enough to handle a series of debt consolidations.[4]

**Option 4: Debt forgiveness**

Even if additional resources could be found, outside help simply adds to public indebtedness and therefore makes the situation worse, not better.

A solution would be a two-step procedure:

- In the first step, the European Stability Mechanism or friendly governments could purchase large amounts of the existing stock of public bonds issued by crisis countries.
- In the second step, a Paris Club mechanism could be set up to forgive these debts.

In effect, this would be a transfer from the better-off countries to the crisis countries.

Plainly this option faces gigantic political hurdles. But the very size of task makes it economically impossible as well. A back of the envelope calculation should dissipate any doubt.

Suppose all the other Eurozone countries forgive a quarter of the debts of Greece, Ireland, Portugal, Italy, Spain and France. This represents a write-down for 'forgiven' countries' debt that amounts to about €1200 billion. That is about 30% of the 'forgiving' countries' GDPs.

To put this into perspective, a 30% jump in Ireland's debt/GDP ratio pushed it from moderate debtor into crisis territory when it rescued its banks in 2010. If the 'forgiving' nations borrowed to cover these losses, Germany's public debt would reach some 110% of GDP, but the Greek debt level would be only back to its pre-crisis level.

It is possible to have a Paris Club solution for a small country. This is in fact the most likely course of action for Greece. The drawback is that, once it is done for one country, it becomes irresistible for others. One may remember how Greece's bailout in May 2010 was then presented as 'unique and exceptional', only to become the norm afterwards.

**Option 5: Debt monetisation**

As often when numbers become too big for governments, the central bank emerges as the lender of last resort. De Grauwe (2011) has made the crucial observation that the fundamental reason why the debt crisis has been circumscribed to the Eurozone is that the markets did not believe that the ECB was ready to backstop public debts.

The success of the ECB's OMT programme so far, in spite of its conditional nature, shows the role that a central bank can play when it moves in the direction of accepting its role as a lender of last resort. But stabilising spreads is merely a temporary stopgap. The legacy of crippling and threatening public debts remains to be dealt with.

This is why debt monetisation emerges as another solution.[5] But a mere purchase of bonds by the ECB will not work for two reasons:

- First, each country must pay interest on its bonds, including those held by the central bank.

These payments would go into the ECB's profits to be paid back to its shareholders, i.e. to all member countries. As shown by De Grauwe and Ji (2013), this would be a transfer "in the wrong direction" from the country being "helped" to the "helping" countries. The only relief to a country would be through its own share of rebated payments.

- Second, when the debt matures, the country will have to pay back the principal.

All in all, the relief is bound to be very limited.[6]

**How the ECB could deal with the debt**

For debt monetisation to allow for relief, the debt must be somehow eliminated once it has been acquired by the ECB. One way of achieving this goal is as follows:

- First, the ECB buys bonds of a country, say for a value of €100.
- Second, it exchanges these bonds against a perpetual, interest-free loan of €100.

The loan will remain indefinitely as an asset on the book of the ECB but, in effect, it will never be paid back (unless the ECB is liquidated).

The counterpart of this operation will appear on the liability side of the ECB's balance sheet as a €100 increase in the monetary base. This is the cost of the debt monetisation.

Debt monetisation has a bad reputation, which is justified by the fact that it has often led in the past to runaway inflation.

Under current conditions, this is most unlikely to be inflationary. Given the icy state of credit markets, increases in the money base do not translate into increases of the actual money supply; in effect, the money multiplier is about zero.

In addition, high unemployment has created a deflationary environment. But, hopefully, the credit market will be revived one day and the recession will come to an end. At this stage, the money base will have to be shrunk. This is the exit problem (Wyplosz 2013). An alternative is to raise reserve requirements to reduce the size of the money multiplier. Either way, the balance sheet expansion need not lead to inflation.

One solution is for the ECB to sterilise its entire bond buying under this programme by issuing its own debt instruments, leaving the size of the money base unchanged. This can be done at the time of bond purchases or later, when exit will be undertaken.

Of course, the ECB will have to pay interest on its debt instruments, which will reduce profits and seigniorage to all member countries, both the defaulting ones and the others. This transfer 'in the right direction' is the way all member countries will share the loss inherent to debt restructuring.[7]

As always, we have to accept the tyranny of numbers. Today's balance sheet of the ECB amounts to €2430 billion. The big bang example examined above would add €1200 billion, an increase of 50%. This is huge, but not unprecedented. In July 2007, the ECB balance sheet was €1190 billion – half of what it is today.

**Conclusion**

At the end of the day, except for Option 1, which is the classic virtuous approach, and Option 2, the disposable of public assets, none of the other options is appealing.

But if Options 1 and 2 are impossible, one has to choose among bad options.

Option 3 is clearly the least desirable because it would shake the markets and possibly take down large segments of the banking system. Option 4 is not just politically explosive; it could trigger a debt crisis among the countries currently perceived as healthy. This leaves us with Option 5.

Of course, defaulting through the ECB is merely a fig leaf to hide the cost of debt restructuring. In addition to spreading the impact over the long run, it has the advantage that the non-virtuous countries will share the costs in the form of reduced profit transfers from the ECB over the long run.

Obviously, debt cancellation entails a huge moral hazard that needs to be dealt with. Here it bears to emphasise that bringing the crisis to an end requires two conceptually different actions:

- One is dealing with the legacy of unsustainable debts, which is what the options presented here do (note that it is proposed to deal with the debt stock legacy, not to finance on-going deficits. A once-for-all action is far less dangerous than a permanent moral hazard).
- The other is to make sure that it will never happen again.

This calls for the adoption of a rock-solid fiscal discipline framework. Solutions other than the ineffective Stability and Growth Pact exist, but this is not the topic of this article. The ECB must require that this be done, and done well, before stepping into the quagmire.

**References**

Bossone, Biagio (2013), "Time for the Eurozone to shift gear: Issuing euros to finance new spending", VoxEU.org, 8 April.

Buiter, W (1985), "A Guide to Public Sector Debt and Deficits", *Economic Policy* 1(1), 13-79.

De Grauwe, P (2011), "The Governance of a Fragile Eurozone", Université Catholique de Louvain.

De Grauwe, P (2012), "The European Central Bank as a Lender of Last Resort", 18 August.

De Grauwe, P and Yuemei Ji (2012), "Mispricing of sovereign risk and multiple equilibria in the Eurozone", VoxEU.org, 23 January.

De Grauwe, P and Yuemei Ji (2013), "Fiscal implications of the ECB's bond-buying programme", VoxEU.org, 14 June.

Giavazzi, F (2010), "The 'stimulus debate' and the golden rule of mountain climbing", VoxEU.org, 22 July.

Goodhart, CAE (1975), "Problems of Monetary Management: The U.K. Experience", Papers in Monetary Economics, Reserve Bank of Australia.

Von Hagen, Jürgen, Ludger Schuknecht and Guido Wolswijk (2009), "European government bond spreads in the current crisis", VoxEU.org, 21 December.

Wood, Richard (2011), "Deflation, debt, and economic stimulus", VoxEU.org, 3 March.

Wyplosz, C (2010), "And Now? A Dark Scenario", VoxEU.org, 3 May.

Wyplosz, C (2011), "Debt Sustainability Assessment: Mission Impossible", *Review of Economics and Institutions* 2(3), 1-37.

Wyplosz, C (2013), "Exit strategies: Time to think ahead", VoxEU.org, 8 June.

---

1 For an early analysis of bond spreads and the EZ (before debt became a crisis), see von Hagen, Schuknecht and Wolswijk 2009.

2 For an early call for an OMT-like programme, see De Grauwe and Yuemei Ji 2012.

3 For a detailed analysis, see Wyplosz (2011).

4 Smart defaults in the form of Brady bonds also require a lender with deep enough pockets.

5 Our proposal is quite distinct from deficit financing proposals (see Wood 2011, Bassone 2013). The distinction between stock purchases and flow financing is extremely important, both from a macro (inflation) and a moral hazard viewpoint. Indeed, a debt restructuring is finite by construction while debt financing is open-ended and potentiality unbounded.

6 None of this occurs in a country that has its own central bank.

7 The ECB debt instruments will in effect be Eurobonds, but with a crucial difference from existing proposals. Eurobond proposals only help the distressed countries by reducing the interest rates that they currently have to offer. Under the present scheme, the underlying national debts are de facto eliminated.