Debt restructuring will not end the euro crisis

Simon Tilford, Centre for European Reform, May 9, 2011

Even as the ink is still drying on Portugal's EU/IMF 'bail-out' agreement, it is becoming clear that Greece's 2010 bail-out has failed to improve the sustainability of its public finances. There are even rumours (strenuously denied) that the German government has drawn up plans for a Greek withdrawal from the currency union. Far from improving access to the financial markets, the support packages for Greece and Ireland (which succumbed to a bail-out of its own in December 2010) have left these countries facing record borrowing costs. The reasons for this are by now well-rehearsed. The markets do not believe that the struggling euro countries are going to grow rapidly enough to service their debts. By increasing their debts further, the bail-outs have made investors even more sceptical. The outlook for Portugal is similar, notwithstanding the slightly less draconian terms of its agreement.

All three countries will eventually have to restructure their debts. Initially, the EU will no doubt try and get away with 'soft' restructurings, involving a combination of longer maturities and lower interest rates. But this will not work and by 2013 there will be no viable alternative to 'hard' restructurings (default) comprising debt write-downs of 50 per cent or more. Unfortunately, in the case of Greece and Portugal at least, even this will not guarantee continued membership of the euro.

Debt restructuring of this scale will be messy and fraught with risks. The eurozone will have to inject capital into the banks of peripheral countries, which have huge holdings of their respective governments' debts. Banks based elsewhere in the eurozone that have large exposures to peripheral country debt will have to raise capital from private investors or from their governments. However, by the time the EU gets around to a 'hard' debt restructuring in 2013, public bodies (EU governments, the ECB and the IMF) will have assumed at least half of the private sector's exposure to the public debt of the defaulting countries. In order to prevent debt restructuring from causing a flight from government debt markets across the rest of the eurozone, the ECB will have to stand ready to provide liquidity and, if necessary, purchase government bonds. The ECB itself will have to book huge losses on the money it lent to banks in the defaulting countries. But assuming all this can be achieved without a systemic financial crisis, what then? Will such a debt restructuring/default solve the crisis?

Cutting the debt burdens of the peripheral states will only go so far to resolving their problems. After all, interest payments on their outstanding public debt account for a relatively small (albeit quickly rising) proportion of their budget deficits. Reducing the cost of servicing the outstanding stock of public debt by 50-60 per cent would obviously improve the long-term sustainability of these countries' fiscal positions. But unless the defaulting countries can engineer a return to economic growth, they will continue to struggle to tap the capital markets on anything but prohibitively expensive terms. Of the three peripheral economies, only Ireland stands a good chance of convincing investors of its solvency.

Assuming Ireland's public debt is written down by around 50 per cent in 2013 (when its debt-to-GDP ratio will have climbed to around 120 per cent of GDP) its debt ratio would be a manageable looking 60 per cent. However, in all likelihood it will also still have a huge budget deficit, which will require on-going budget austerity. In Ireland's case investors will probably calculate that the Irish economy will be strong enough to weather continued austerity. Ireland is now running a current-account surplus – so it is not dependent on foreign borrowing to finance the deficit and the foreign balance is not a drag on its economy. There will be no return to Celtic Tiger rates of

expansion, but the country's export sector is competitive. Exports should perform relatively strongly, holding out the promise of decent economic growth. As a result, Ireland could regain access to financial markets relatively quickly following a 'hard' debt restructuring.

What about Greece and Portugal? In both cases the picture is bleaker. Assuming that the ratio of Greek debt rises to over 160 per cent of GDP before the EU finally pushes ahead with a 'hard' restructuring involving a write-down of as much as 60 per cent, the country would have a debt to GDP ratio of 65 per cent. However, investors will be sceptical of the Greek economy's ability to absorb the cuts needed to bring down the still very large budget deficit. The Greek government will be largely dependent on foreign borrowing to finance the budget deficit: Greece's current-account deficit has narrowed, but remains very large. Unlike Ireland, Greece will find it very hard to generate the stimulus from exports needed to offset the impact of continued austerity. Exports only account for around 25 per cent of Greek GDP – compared with well over 100 per cent in the Irish case – and Greece does little trade with countries outside the slow-growing EU. Investors will surely bet that they will not get bailed out by taxpayers a second time, and continue to deny Greece market access.

What about Portugal? Portugal has a lower stock of public debt than Greece – at around 95 per cent of GDP – but it has a very sizeable budget deficit, hugely indebted private sector and current account deficit of a comparable size to Greece's. The combined debt of Portugal's public and private sectors (excluding debts between banks) is now around 300 per cent of GDP. A chunk of this private sector debt will end up on the government's books. Under its agreement with the EU and IMF, Portugal has to underwrite €35bn of its banks' liabilities – equivalent to around 20 per cent of its GDP. But with the Portuguese economy set to contract steeply over the next two years (the EU forecasts falls in GDP of 2 per cent in both 2011 and 2012) the eventual transfer of debt from the private to the public sector is likely to be substantially higher than $35 billion.

If, as seems likely, the ratio of Portugal's public debt to GDP rises to close to 120 per cent by 2013, a 50 per cent write-down would reduce the debt to around 60 per cent of GDP. But with the fiscal deficit large and export-led growth elusive, investors will remain wary of lending to the Portuguese government. Portugal's economy is more open than Greece's, but nowhere near as open as Ireland's, and does similarly little trade with non-EU markets. Moreover, the country's principal export market – Spain – faces years of economic stagnation as it grapples with problems not dissimilar to those of Portugal. Portuguese businesses have also experienced a huge loss of trade competitiveness within the eurozone. Added to this, the euro is likely to remain very strong against the dollar as the US Federal Reserve maintains a loose monetary policy and the ECB raises interest rates.

What will then happen? Further bail-outs of Greece and Portugal in the form of loans from the rest of the eurozone are unlikely. Everyone will by then recognise that piling more debt on top of already unsustainable levels makes little sense. This will leave two alternatives: fiscal transfers (the dreaded 'fiscal union') or a withdrawal of the affected countries from the currency union. Faced with the possibility of countries leaving the currency union, it is impossible to discount the possibility of a shift to some kind of transfer union. But the politics look formidably difficult. Could there be a negotiated withdrawal from the currency union? It would require action on a number of fronts, including emergency support for the affected countries' banks and the imposition of temporary capital controls. The quitting countries' debts would have to be redenominated into their newly introduced (and massively devalued) currencies. The rules stating that any country leaving the currency union would have to quit the EU would also have to be fudged. It is impossible to attach a likelihood to all this happening. But given the obstacles to fiscal transfers between eurozone economies it would be unwise to bet too much money against it.