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Brady Bonds For the Eurozone

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Rather than continuing to pile new debts onto bad debts, the EU stabilization fund could be used to collateralize such new par bonds.

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WASHINGTON, DC – Today's conventional view of the eurozone is that the crisis is over – the intense, often existential concern earlier this year about the common currency's future has been assuaged, and everything now is back under control.

This is completely at odds with the facts. European bond markets are again delivering a chilling message to global policymakers. With bonds of "peripheral" eurozone nations continuing to fall in value, the risk of Irish, Greek, and Portuguese sovereign defaults is higher than ever.

This comes despite the combined bailout package that the European Union, International Monetary Fund, and European Central Bank created for Greece in May, and despite the ECB's continuing program of buying peripheral EU countries' bonds. Heading into its annual meetings in a few weeks (followed by the G-20 summit in Seoul in November), the IMF is bowing to pressure to drop ever-larger sums into the EU with ever-fewer conditions.

Indeed, official rhetoric has turned once again to trying to persuade markets to ignore reality. Patrick Honohan, the governor of Ireland's central bank, has labeled the interest rates on Irish government bonds "ridiculous" (meaning ridiculously high), and IMF researchers argue that default in Ireland and Greece is "unnecessary, undesirable, and unlikely."

This is disconcertingly reminiscent of the spring – when Jean-Claude Trichet, the ECB president, lashed out at a skeptical bond market and declared a Greek default unfathomable. But markets today think there is a 50% chance that Greece will default within the next five years – and a 25% chance that Ireland will do so. The reason is simple: both Greece and Ireland are likely insolvent.

While the Greek fiscal fiasco is now common knowledge, Ireland's problems are deeper and less widely understood. In a nutshell: Ireland's policymakers failed to supervise their banks, and watched (or cheered) from the sidelines as a debt-fueled spending binge generated the "Celtic miracle," whereby Ireland grew faster than all other EU members and Dublin real estate became some of the most expensive in the world.

By the end of 2008, Ireland's three main banks had lent more than three times the country's national income. The crash came in 2009, as Ireland's real estate boom turned to bust, leaving the country with large insolvent banks, a collapse in budget revenues, and Europe's largest budget deficit.

Ireland's banks financed their rapid growth by borrowing from other European banks, so the health of Europe's financial system has become entwined with the survival of these insolvent banks. It is no surprise that the ECB is now Ireland's largest creditor – through buying up its government bonds. In the latest data (through the end of August), despite being two-thirds the size, Ireland received more ECB financing than Greece – totaling 75% of Irish GNP and growing rapidly.

The *quid pro quo* for this easy ECB money is that the Irish government must protect European creditors who would otherwise face large losses. The ensuing massive bank bailout, plus continued budget deficits and declining nominal GNP, means that Ireland's debt is ballooning, while its capacity to pay has collapsed.

Investors naturally respond to unsustainable debt by selling bonds until interest rates become "ridiculous." Those high interest rates strangle businesses and households, causing further economic collapse and making debt ever more unsustainable. To halt this downward spiral, Ireland's risk of insolvency needs to be put to rest. Either banks need to default on their senior obligations, or the government will need to default alongside the banks. In either case, new austerity measures are needed, and Ireland will require substantial bridge financing.

Irish and EU politicians should take the lead in making these tough decisions, but the current leadership will not. Instead, the EU, the ECB, and Ireland have reached a Faustian bargain that keeps Ireland liquid (i.e., it gets euros), but does nothing to halt the growing likelihood of insolvency (i.e., its increasing inability to pay back those euros in the future).

The IMF, which should be standing up to this dangerous bargain, instead plans to open the spigots (with Chinese, American, and other countries' funds) even more widely to insolvent nations. On August 30, the Fund abolished ceilings on its "Flexible Credit Line" facility, which was introduced in 2009 to provide rapid funds to countries in temporary crisis.

Moreover, the IMF announced a new financing program called a "Precautionary Credit Line," which will provide funds more quickly and with even fewer conditions – even to countries without "sound public finance" and "effective financial supervision." The Fund is also hoping to establish a new "Global Stabilization Mechanism" to provide credit lines to regional groupings (like the EU).

A European politician heads the IMF, its board of directors is far more weighted towards Europe than is justified by Europe's economic relevance, and it is rushing to ease lending conditions to Europe just as EU members are suffering deep insolvency problems.

There is a better solution, pioneered after commercial banks in the United States loaned too much to Latin America in the 1970's. Sovereign debt was eventually restructured through the creation of "Brady bonds." The trick was to offer banks the opportunity to swap their claims on (insolvent) Latin American countries into long-maturity, low-coupon bonds that were collateralized with US Treasuries.

The good collateral meant that banks could hold these debts at par on their balance sheets. At the same time, this swap reduced troubled countries' debt-payment obligations – allowing them to get back on their feet.

Europe could take this route. Rather than continuing to pile new debts onto bad debts, the EU stabilization fund could be used to collateralize such new par bonds. Creditors could be offered these par bonds, or a shorter-term bond with a higher coupon – but with debt principal marked down. The new bonds could be known as Trichet or Merkel/Sarkozy or Honohan bonds – whatever works to build consensus.

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