DOC. N.º 56

The Baseline Scenario

What happened to the global economy and what we can do about it

The Debt Problems of the European Periphery

Posted on November 17, 2010 by Simon Johnson | 46 Comments

By Anders Åslund, Peter Boone and Simon Johnson

Last week's renewed anxiety over bond market collapse in Europe's periphery should come as no surprise. Greece's EU/IMF program heaps more public debt onto a nation that is already insolvent, and Ireland is now on the same track. Despite massive fiscal cuts and several years of deep recession Greece and Ireland will accumulate 150% of GNP in debt by 2014. A new road is necessary: The burden of financial failure should be shared with the culprits and not only born by the victims.

The fundamental flaw in these programs is the morally dubious decision to bail out the bank creditors while foisting the burden of adjustment on taxpayers. Especially the Irish government has, for no good reason, nationalized the debts of its failing private banks, passing on the burden to its increasingly poor citizens. On the donor side, German and French taxpayers are angry at the thought of having to pay for the bonanza of Irish banks and their irresponsible creditors.

Such lopsided burden-sharing is rightly angering both donors and recipients. Rising public resentment is testing German and French willingness to promise more taxpayer funds. German Chancellor Angela Merkel's hasty and ill thought out plan to demand private sector burden sharing, but only "after mid-2013", marks a first response to these popular demands. We should expect more.

Financial crises are actually not rare, and the rules for their resolution are clear. The fundamental insight is that huge amounts of financial losses, of seemingly real value, need to be distributed across creditors, debtors, equity holders and taxpayers. The first step is to bring the current budget deficit under control to achieve a primary balance, which both Greece and Ireland are now attempting. The second is to attract sufficient emergency funding, which the IMF and the EU essentially have done. But in neither Greece nor Ireland is that sufficient. They still have unaffordable debt burdens. Therefore, one more measure is needed, namely a reduction of the public debt.

The public debt can be contained in two ways. The first and preferable option is that the state never nationalizes private bank debt as Ireland has done. For Ireland, this opportunity has probably passed, but other countries should be warned not to make the same mistake. Kazakhstan's refusal last year to bail out its major banks, despite strong demands from the senior creditors of these banks, has proved a far more successful path. Banks can and should go under if they have failed. The state should only defend small and medium-sized depositors.

If the state has taken on too large debt, sovereign default is the natural outcome. In their excellent book *This Time Is Different*, Carmen Reinhardt and Kenneth Rogoff argue that 90 percent of GDP is the highest sustainable level of public debt for a developed country. This limit is not absolute, but there is little reason to believe that Greece and Ireland would belong to the exceptions. As Germany and France so sensibly, though perhaps not very cautiously, have argued in public, the EU needs a facility for sovereign debt default.

Sovereign defaults are always contentious, but they don't need to end in catastrophic financial collapse. This is especially so in Europe, as Lee Buchheit and Mitu Gulati have argued in a well-read paper on "How to Restructure Greek Debt," because over 90% of these debts are issued under domestic law. Troubled nations, as part of their rescue plans, can and should introduce legislation that permits a qualified majority of creditors to change terms on outstanding sovereign and bank debt, while protecting bank deposits. Such rules could, for example, require 2/3 of non-protected creditors agree to a restructuring plan. This reduces the risk that holdouts can prevent a deal from being reached, but still gives creditors clear powers to negotiate terms.

Well-planned debt restructuring will not cause a systemic financial collapse. It is misleading to draw parallels from the chaotic liquidation of Lehman Brothers for the outcome of debt relief in Europe. The direct impact of debt relief for Greece, Ireland and others is easily measured and managed. The debtors and creditors are well known.

If Greece's reform program included a write-down of 50% (in net present value) on its debts, and they received an additional 20% of GDP in bridge financing over the next three years, its debt burden in 2013 would be a comfortable 80% of GDP. As Greek debt already trades below face value, the total additional losses to creditors could amount to 35% of debt, or approximately 100bn euros. Ireland is smaller so total costs should be less. This debt relief could be conditional on successful implementation of IMF monitored programs, similar to traditional Paris Club debt restructurings. Fears that debt relief could spark panic selling and contagion in other debt markets can be arrested through temporary interventions by the ECB, and the EU needs to publicly declare strict criteria when debt restructuring may occur.

Opponents to debt relief for Greece and Ireland are wrong to think that Europe's current strategy makes Europe safe from systemic collapse. The implied risk of default on Spanish, Italian and Portuguese debt rose sharply during the last month as concerns over Ireland and Greece spread, and this in turn caused yields on related bank debts to soar. The potential economic time bombs left in Europe's periphery are growing. They can and must be resolved. Otherwise the economic and political risks might become overwhelming.

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46 RESPONSES TO "THE DEBT PROBLEMS OF THE EUROPEAN PERIPHERY"

Nemo | November 17, 2010 at 12:27 am |

This proposal assumes that someone other than the banks are making policy.

StatsGuy | November 17, 2010 at 12:32 am |

Are you slightly concerned about CDS contracts for Greek debt underwritten by Greek banks? Which without public backing are nearly worthless, leaving creditors who think they're protected somewhat less protected.

I don't see how contagion would be stopped unless strict rules were laid out specifying losses, so that creditors would know how much they might lose – otherwise, panic. And even then, it's hard to isolate an event due to the uncertainty surrounding derivatives (and especially counterparty risk). By which I mean:

If Greece and Ireland go (at 50% markdown), creditors and CDS underwriters cover some amount – quite possibly, Spanish/German/French banks find themselves underwater, but how much underwater no one knows until the entire chain of CDS unwinds. Hopefully, European states have spent the last year getting a grip on the derivative obligations, and preparing to deal with them.

Hope has been rather disappointing lately.

StatsGuy | November 17, 2010 at 12:46 am |

As an aside, have you seen the price of state municipal bonds lately? Europe redux?

Fundamentally, there are deep "imbalances" that go well beyond the US/EU/China trade triangle, although they're quite related. The issues are distributional, but no one wants to call it as they see it.

In many places, one piece of society owes another piece more than it's good for. Society at large realizes that perpetual payment is unlikely, and is discounting obligations. This means financial shock, and hence, underinvestment and NGDP misses. Monetary authorities refuse to commit to compensate, largely because they're afraid that this will merely enable fiscal authorities to defer the day of reckoning (which now seems true – hope is dead on the vine).

With every day of insufficient NGDP growth and failure to implement needed structural changes (such as reducing obligations to overpaid civil servants and retiree overhangs, and

European Financial Institutions and corporations and persons residing in the currency union.

And in so doing he will command great authority. An example of such authority is EU's Economic Affairs Commissioner Olli Rehn's October 2, 2010 statement in FT article, Ireland May Have To Sacrifice Low Tax Status: "In the coming decade, it's a fact of life that after what has happened, Ireland will not continue as a low-tax country, but it will rather become a normal tax country in the European context," he said.

I believe the seignior (perhaps it will be Mr. Rehn), will pave the way for a global currency system, to replace all current currencies, as they expire in the current bout of global debt deflation that commenced that November 5, 2010, when the currency traders sold most of the world's currencies, as the bond vigilantes sustained the Interest Rate on the US 30 Year Government Bond above 4%, causing the US Dollar, to rise.

Evidence abounds, and is clear, cogent and convincing that fiscal seigniorage has failed in Europe. As the end of credit approaches, then a Supra Government, of the Sovereign And Seignior, will be the Federal Government of Europe, and sole fiscal and credit seignior. This triune power will be the first, last and only provider of credit in the Eurozone.
