Time for "Plan B" in Europe?

Edwin M. Truman assesses the factors in Europe's financial turmoil and suggests that policymakers start thinking about a "Plan B" entailing debt restructuring.

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Steve Weisman: With turmoil in the financial markets in Europe growing, Ted Truman of the Peterson Institute for International Economics is here to discuss the factors and implications. This is Steve Weisman at the Institute. Thanks, Ted.

Edwin Truman: My pleasure.

Steve Weisman: Is the crisis in Europe in the financial markets, and especially the bailouts of Greece and Ireland and possibly other countries, threatening the existence of the eurozone and the solidity of the euro itself?

Edwin Truman: I don't think we're there yet. But I think things are worse than they were six months ago when they were rescuing Greece. I think what you have here is a collective run on the financial institutions and the governments of the eurozone countries. They are bound together because of various government guarantees and rescue and bailout plans, and the issue is whether the current structures of rescue for Greece and Ireland and perhaps Portugal will be enough to sort of stem the tide, or whether the system will have to go to what I think of as plan B.

Steve Weisman: What is plan B?

Edwin Truman: I think Plan B is what some people have been calling for a long time a structured process of writing down bank debts and government debts in some combination.

Steve Weisman: Existing debts?

Edwin Truman: Existing debts, to lower the burden of those debts. But then you have to worry about the impact on those institutions and even individuals holding that debt. So you take a debt of 100 and you write it down to 50. Then someone has 50 less in terms of net worth. That person is a German bank already scraping on with very little capital. Then you have to have a plan to restore the capital of the German bank.

Given how integrated the European economy is in real terms, trade terms, and economic terms, as well as financially, these things will have huge knockout effects. You need to manage the process of write-down. You can't do it [the way it has been done]: First you do Greece one way, and then you do Ireland another way, and then you do Portugal a third way, and so forth.

You need to have an overall plan for how you're going to apply the write-downs and how you're going to support the economies and the financial systems—of Greece, Ireland, Portugal, Germany, and France and Italy and Belgium and Netherlands—[subject to] the backwash effect of the write-downs.

Steve Weisman: But doesn't merely talking about this sort of plan spook the markets and make the problem worse?

Edwin Truman: Yes, I think that's right. That's what's essentially happened. They have been talking about this, saying, "Well, later on we're going to do this sort of thing." That spooked the market.

Steve Weisman: You are referring to doing something after 2013.

Edwin Truman: After 2013. Then they would impose [write-downs on debt]. Now they're thinking of that only as an option. But they were talking about mandatory basis. The problem is that even if you apply that type of regime starting with debt issued after 2013, that does not actually guarantee debt today. We're dealing with sovereign debt issued under domestic sovereign law. And a piece of paper that says, "We might be restructuring you starting in 2013 new debt," doesn't exempt the old debt, which is on the books now.

And the more they talk about doing it in the future, the higher the probability is that they will do it today. All they have to do is pass a new law which says, "A euro worth of debt is now worth half a euro worth of debt." They can do that. Each individual country can do that unilaterally without any negotiation. That would be messy. That's why you need plan B. If you're going to go that route, you need a plan in order to control the consequences.

Steve Weisman: This is reminiscent of the dilemma faced by policymakers in 2008–09. When rescuing the system, can you inflict haircuts or discounts on the debt held within the system? The United States resolved it in one way, but with a political backlash. Are there any lessons to be learned by the Europeans from what the United States did?

Edwin Truman: Probably the lesson is, "Don't go there if you can avoid it." It is very analogous. If you are trying to rescue a particular institution—and the most prominent one in our case was AIG—you rescue it. But you're not rescuing AIG because you're rescuing AIG. You're rescuing AIG because you're rescuing the system. If you had simultaneously said, "But we're going to pay off the creditors to AIG at 90 cents on the dollar," then you're actually saying, "Well, we're going to impact Goldman Sachs, and Citigroup, and Deutsche Bank, and UBS, and all the holders of claims on AIG." And that would have perpetuated the crisis.

So they paid [the debts] off, at 100 cents on the dollar. And now in retrospect they say, "Why are we paying those creditors off when we should have forced them to take a write-down?" If you forced them to take a write-down, you would have accelerated the run on the global financial system. That was a feature of the post-Layman bankruptcy environment. And that's where the Europeans are themselves saying, "Well, maybe we're going to force a write-down." And that is perpetuating or increasing the risk of holding all forms of financial claims on European governments and financial institutions.

The very fact, for example, that the German 10-year bond rate has risen relative to the US 10-year bond rate over the last several months is illustration of the fact that Germany, which was trading at better rate than the United States in bonds, is now trading at much lower rate. So it's even impacting the price that Germany pays for issuing debt.

Steve Weisman: The Germans have preached fiscal virtue to Ireland and Greece and the other errant countries in Europe. Yet it was the German banks, along with the French banks, that were most vulnerable because of their loans in the countries in trouble. How do you assess German handling of this crisis?

Edwin Truman: Two points can be made. One is that increasingly it's clear that whatever was going wrong in the supervision of German banks, it was the German supervisors who said, "It's fine to lend all you want to Greece and Portugal and Ireland." That probably was, in retrospect, a mistake.

But it's hard to blame the United States and the bankruptcy of Lehman Brothers for all this. This is a purely homegrown European crisis. The 2010 European crisis may have been precipitated as a byproduct of the global financial crisis. But it is homegrown in terms of the way European institutions operate—politically, economically, and financially—or don't operate in a smooth manner. And that comes back to the question you raised about the future of the euro.

The political support for the European project, which is an incomplete project in my view, can only be reduced in all countries as a result of what happened there over the last 10 to 11 months of 2010.

Steve Weisman: What about the overlay of national interests in Europe that there was not in the United States? The Irish are suddenly waking up to the fact that they owe the money to banks in Germany and France or other countries.

Edwin Truman: I think that's right. But the analogue in the United States is Main Street versus Wall Street. Wall Street is in New York, right? We rescued the Wall Street financial institutions. And Main Street paid for it. Now Main Street is Ireland, and Wall Street is Germany. But you're right in terms of the political process. It looks like they're inherently more nationalistic than we are. I think the centrifugal forces here are quite large and the risk is that things will break down.

The optimist will say, "It's a crisis, we'll pull them all back together." But it's going to be a little difficult, I think, after all they've gone through for the leaders—to say nothing of the general populous—to get together and say, "We really think it's a good idea, this European project." It's going to be hard to do. I think one should be a little bit optimistic. I don't think [a debt write-down] is inevitable, like some of our colleagues. I think there is some chance that the turmoil in financial markets is a function of this being December, and nobody is willing to take on new debt. They're squaring their positions. And if they make it through to January and global economy is not looking so bad, and the US economy is picking up, it may well be that they'll skate through without having to go to plan B. But if I were in the responsible position in our government or other governments of the International Monetary Fund, I'd be working hard on plan B in case, come January 15, they have to go there.

Steve Weisman: Are you implying that the US would have a role to play in plan B?

Edwin Truman: Yes, because there probably would be additional IMF support involved. And indeed I don't know all the data, but presumably this would impact, either directly or indirectly, US financial institutions. Certainly if it throws the European economy into recession, rather than 1.5 percent growth next year, which is recently protected by the European Commission, that would impact the US economy. So we the United States have a stake in how they manage this process either on the current trajectory or a plan B trajectory.

Steve Weisman: Are the Europeans still blaming us for the crisis?

Edwin Truman: I think the 2010 phase of this crisis that started in 2007 is very difficult to blame on the United States. No doubt some people can and will. Some of all this finance is copycat finance. But to an extent it comes from failures of macro policy on the fiscal side. In some cases, Greece in particular or regulatory policy in particular in Ireland, these are all consenting adults. [European banks] may profit from lending and not seeing this come. There is responsibility in the one hand, but it's in some sense also European responsibility. They are supposed to use peer pressure on their peers.

Steve Weisman: Ted Truman, thanks very much.

Edwin Truman: You're welcome.