Resolving the European Debt Crisis:

Conference Summary

On September 13-14, the Brussels-based think tank BRUEGEL and the Peterson Institute for International Economics hosted a conference on Resolving the European Debt Crisis. Held at a conference center near Paris, the event assembled about four dozen policy experts and practitioners, mainly from Europe and the United States. The conference was designed to contribute to a better understanding of the implications of alternative approaches to resolving the crisis, in particular, the dynamics of interaction among various stakeholder groups as policy decisions evolve. Support for the conference was provided by Tudor Investment Corporation and BlackRock Investment Management.

Conference structure -- On the first day there were three panels aimed at providing a comprehensive understanding of the current and prospective situation surrounding the European debt, financial and economic problems. The first of these assessed the current economic and political situation in the key Eurozone creditor and debtor nations and the associated constraints facing policymakers. The second focused on the lessons learned from past experiences of sovereign debt crises and their resolutions, including with respect to legal and accounting issues, and their relevance for current European circumstances. The third analyzed the pros and cons, including the costs and benefits, of the different options available to policymakers to bring the Eurozone debt crisis to a successful resolution.

On the second day, a simulation game took place among the conference participants in what amounted to a stress-test for European debt policy. The game was directed by Andrew Gracie of Crisis Management Analytics (http://www.crisismanagementanalytics.com). Gracie is a former member of the Bank of England's Financial Stability Group with a strong track record in running simulated games for central banks globally. No sitting officials participated and the game was played under Chatham House rules. Participants played the roles of the governments of France, Germany, Greece, Ireland, Italy, Portugal, and Spain; decision-makers for the ECB, IMF, and United States; and decision-makers in commercial banks in the countries involved and non-bank financial market actors. In addition, in response to successive rounds of the game as it developed, other participants provided expertise in the areas of credit ratings, legal and accounting issues, and political repercussions. ***Background and Policy Discussion***

The country papers on the political-economic environments in Greece, Ireland and Portugal revealed a strong degree of domestic political support for fully honoring sovereign debt obligations and remaining in the euro. The papers and discussion on the recent market deterioration in the much larger economies of Italy and Spain underscored the need for Eurozone institutional reform providing for much greater fiscal integration. Such reform would make it possible to spread the umbrella of creditworthiness of the stronger countries by enforcing far more central control on fiscal policies. There was an accompanying sense that the time inconsistency between the near-term emergency and the lengthy process of building new Eurozone institutions poses an unresolved problem.

The best vehicle for forceful action in the bridge period was generally seen to be the ECB. Several participants had misgivings about the ECB's involvement in sovereign debt purchases and the prospect that it might need to expand those purchases on a much larger scale, however, and others urged that the ECB send a strong signal that future support would be highly conditional on prompt fiscal adjustment. For France, the session revealed an intense commitment to sustaining the euro. For Germany it was emphasized that any notion of exit from the euro remains very much a minority view.

COUNTRY POLITICAL-ECONOMIC ENVIRONMENTS

Greece -- The country paper by Loukas Tsoukalis (University of Athens) observed that it remains to be seen whether Greece will prove to be the odd man out or the precursor of things to come elsewhere in Europe. Tsoukalis indicates that, whereas early polls showed acceptance of the inevitability of austerity measures, Greeks are increasingly angry and see no light at the end of the tunnel. He sees the need for a radical renewal of the political class, although at present the current government has the best chance of implementing the needed adjustment and reform.

The decisive battle in Greece today is about rationalizing a bloated and inefficient public sector. Tsoukalis considers that the July 2011 support package was a great improvement but judges the private sector involvement (PSI) portion of it to be costly and cumbersome. In general discussion, it was argued that so far there had been too much austerity and too little reform (such as deregulation), and that cacophony in the Eurozone was making country adjustment efforts more difficult. It was agreed that, although there was little political consensus, there is widespread agreement within Greece that bankruptcy-type debt restructuring should be avoided and that Greece must remain in the euro.

Ireland – The paper by Alan Ahearne (National University of Ireland, Galway) emphasized that Ireland has already carried out fiscal adjustment amounting to 13 percent of GDP and that the total adjustment will reach 20 percent. He stressed the degree of internal devaluation, citing a 15 percent cut in public sector wages over the past three years. He noted the strong consensus that the sovereign debt must be paid in full because Ireland as a small economy dependent on international investment and trade must honor contracts.

However, he also indicated the distinction in domestic political perceptions between sovereign debt resulting from budgetary deficits and exceptional debt attributable to emergency support of banks. At about 40 percent of GDP the latter is larger than in almost any other international experience. Controversy about treatment of senior bondholders of bank debt had notably involved ECB opposition to any haircuts. However, except for a small portion of this debt the government has put this issue in the past.

The current government has an unusually large majority in parliament and the next general election is in 2016. In the discussion, one intervention indicated that the ECB had judged any savings through senior bank bondholder haircuts to be far too small to warrant the associated market disruption. More broadly, discussion during the course of the day tended to reiterate the view that Ireland has gone the farthest and fastest in its adjustment to the crisis.

Portugal – The paper by Pedro Lourtie (former Portuguese Secretary of State for European Affairs) emphasized that there is broad political support for the adjustment program and that the new government has a comfortable majority in Parliament. In assessing Portugal's performance before the global crisis, he argues that during its period of slow growth since 2001/2002 the country entered a path of slow adjustment to the new euro monetary setting and to regaining lost competitiveness. He stresses that, with the sovereign debt crisis hitting the euro area, such a soft approach ceased to be an option. Furthermore, he underlines the importance of crisis contagion to the most vulnerable euro area economies during the current sovereign debt crisis and emphasizes the importance of external events and euro area decisions in influencing market spreads for Portugal.

Lourtie emphasized that in 2011 Portugal entered a phase of hard adjustment and stresses that the country is following an ambitious road-map of fiscal consolidation and structural reforms included in the adjustment program. Overall structural fiscal adjustment targeted over the 2011-2013 period amounts to 9 percent of GDP, with half of that adjustment in 2011. He argues that Portugal has the political and economic conditions to come out stronger and more competitive from this adjustment, and emphasizes that the continuation of strong export growth is a key element. He also underlines that the stabilization of the broader euro area context is essential.

Italy -- Riccardo Perissich (Council of the United States and Italy) began with the observation that although Italy's debt is large (relative to GDP and third behind the United States and Japan in absolute size), it had maintained fiscal balance for a decade before the crisis and there are large private savings. The economy has a strong manufacturing sector. Contagion from Greece in July 2011 forced a new fiscal package, which unraveled because of internal dissention in the majority party. In the face of heightened market pressure, by the end of August the government agreed a new package cutting tranfers to local authorities, raising the capital gains and value added taxes, and renegotiating the social security system.

Spain – Guillermo de la Dehesa (Centre for Economic Policy Research) argued that Eurozone leaders made a serious mistake to avoid early IMF involvement in Greece as a stigma, even though the UK, Italy, and Spain had IMF programs in the late 1970s. He stressed the strong growth record that Spain had achieved. Its fiscal position had been excellent in 2007 and its debt to GDP ratio was less than two-thirds the levels for France and Germany. Lower interest rates with adoption of the euro, and massive labor immigration, had spurred Spain's growth. But large external imbalances resulted from fast growth (not an increase in relative wages) and the bursting of a property bubble in the financial crisis provoked a sharp recession in the global financial crisis.

The government responded with fiscal stimulus even as revenue was falling, leading to a budget deficit of 11 percent of GDP in 2009 (with about one-third attributable to unemployment benefits for 21 percent of the labor force). Adjustment is now under way, with the deficit to be cut to 6 percent of GDP this year and a target of 3 percent by 2013. A new constitutional rule limits growth of government spending to that of the economy. Labor reform will increase flexibility. The banking system is efficient and performed well in the recent stress test.

France -- Zaki Laidi (SciencesPo) focused on the tensions between the French anti-capitalist tradition and the necessities of crisis management. Even the Socialist party now agrees to the goal of a zero fiscal deficit. The President sheltered the French banks and the public sees the banking system as a public service necessary to maintain. France sees an increasing role for Europe and domestic support for the euro is increasing (polls show 61 percent favoring the euro, with those calling for a return to the franc falling to 29 percent from 38 percent in May 2010).

There is also support for financing Greece and increasing support for European fiscal federalism. Laidi also stressed the unusually strong power of the President in the French system, facilitating decisions though not consensus-building. The crisis has shown the French model is vulnerable to market pressures, likely placing a premium on a technocratically sound candidate in the next election.

Germany -- Daniela Schwarzer (Stiftung Wissenschaft und Politik, SWP) began with the reminder that Germany accounts for 28 percent of Eurozone GDP. It has come out of the global crisis quickly, with 2.9 percent growth in 2011. Its fiscal deficit is down to 1.7 percent for 2011 and will be zero in 2014. In the present crisis, Chancellor Merkel has committed to "do whatever it takes" to maintain the euro.

Although the government has a comfortable margin in Parliament, it is seen as weak. Its crisis management strategy has little public support and the coalition parties have lost regional elections. For the Eurozone crisis it was a great relief that the constitutional court approved the EFSF, and the Bundestag is likely to ratify it despite two-thirds opposition to it in the polls. Much of the public feels it has lost the EMU it once joined, and fears inflationary consequences of ECB intervention in the debt crisis. In the discussion, there was a sense that, as and when fiscal federalism comes to the Eurozone, it will be on German terms. Some expressed concern that the consequence could be a contractionary bias.

LESSONS FROM PAST RESTRUCTURING EXPERIENCE

Economic – Jeromin Zettelmeyer (European Bank for Reconstruction and Development) identified five lessons from restructuring experience in 1998-2008. First, collective action problems are overrated; excluding Argentina, creditor participation was high and average completion only 13 months. Second, purely voluntary exchanges rarely work. Uruguay 2003 was soft but not voluntary. Third, market-perceived haircuts substantially exceed debt relief for the country because markets discount at a high "exit" risk premium whereas the proper discount rate from the standpoint of the country is somewhere between the risk-free rate and the country's borrowing rate in normal times. Fourth, markets punish haircuts, especially if they derive from lack of willingness rather than lack of ability to pay. New research showed that a 20 point increase in the haircut boosts borrowing costs by 150 basis points in year 1 and 70 basis points by year 5. Also, a coercive approach to debt restructuring significantly reduces access of domestic firms to foreign credit. Fifth, preventing a banking crisis is the key to avoiding severe output loss from debt restructuring.

Legal – Lee Buchheit (Cleary Gottlieb) also emphasized avoiding a banking-crisis consequence of restructuring, which is difficult to do where local banks are heavy holders of the government's debt. His

list of lessons further included avoiding excessive delay before facing up to unsustainability of the debt; keeping accurate accounts of public debt including off-balance-sheet provincial “quasi-sovereign” likely to be seen as public by foreign holders; asking for enough relief rather than needing three or four rounds of rescheduling as in Latin America in the 1980s and calling on the IMF to help identify the right balance between financing needs and excessive relief; being efficient (and mark to market bondholders of the present have a greater incentive for speedy resolution than bank-loan holders of the 1980s); and being even-handed instead of discriminatory among creditor groups. He noted that peripheral Europe has a unique advantage in that its debt is under national law rather than law of another jurisdiction. He emphasized that in a fair deal, if necessary, national law could be amended to identify a high but manageable majority approval required. He also noted that some calls for collateral against EU support could raise issues of negative pledge clauses in existing bonds and loan contracts. In discussion, Buchheit answered a query about contractual implications if the euro were to break up by indicating that, if the contract were under the law of a country that had exited, its obligation could be converted to the new local currency despite an original euro denomination.

PROS AND CONS OF ALTERNATIVE POLICY OPTIONS

PIIE—The paper by William Cline (Peterson Institute for International Economics) argued that the European debt crisis is primarily one of confidence. Examining the severity of the debt problem in each of the five countries, Cline first considered prospects for debt sustainability in Greece. He calculated that the July 2011 package provides the basis for reducing the gross debt to GDP ratio from 170 percent to 113 percent by 2020. He stresses that there is a misleading increase in gross debt from the collateral assets set aside for PSI exchanges and that Greek net debt shows considerably less burden, at 120 percent now falling to 69 percent of GDP by 2020. Similarly, the interest burden falls from 7.2 percent of GDP to 5.2 percent by 2020 instead of rising to 9 percent without the interest relief in the EU package decided in July. The package involves an ambitious but feasible fiscal target (primary surplus of about 6 percent of GDP) as well as sizable privatizations (€50 billion). The PSI package (€135 billion) and the lengthening of maturities for EU support remove the liquidity squeeze by covering amortization through 2020. Cline thus judges Greek debt to be sustainable given the new package.

Consideration of debt sustainability also finds Ireland and Portugal to be solvent. The sustainability test is that the primary fiscal surplus is large enough to equal or exceed the debt/GDP ratio multiplied by the difference between the interest rate and the nominal growth rate; both countries pass this test. Italy and Spain also meet this sustainability test. However, if they were to face a serious liquidity squeeze the financing needs combined could be on the order of €1 trillion through 2015 for debt coming due.

Cline then examines a spectrum of restructuring and buyback policy options as well as three broader changes: expansion of the EFSF, issuance of Eurobonds with joint guarantee by Eurozone members, and outright exit from the euro (either by weak countries or by strong countries establishing a new strong currency). Ireland and Portugal have the mildest options on the spectrum, Official Refinancing Only; Greece, the next, Refinancing with Voluntary PSI. More severe Restructuring with Moderate Debt Reduction, like the Brady Plan’s 35 percent haircuts, and Restructuring with Deep Debt Reduction, like Argentina’s 70 percent haircut, are more drastic options that Cline judges currently unnecessary even

for Greece. At the moderate end of the spectrum an important market-friendly option is repurchases of debt at a discount, by the country or by the ECB.

The need for the various approaches will depend on the future severity of the problems. Expansion of the EFSF by three- or four-fold could be necessary to deal with acute liquidity stress for Italy and Spain. For the Eurobond alternative, Cline makes a calculation relating risk spreads to country ratings and finds that the weighted average spread for all Eurozone countries would be only 40 basis points above the German benchmark. The direct costs could be 0.3 percent of GDP annually in higher interest payments for Germany and France but with interest savings of 0.6 percent for Italy (in normal times), 1.3 percent for Ireland, 1.9 percent for Portugal, and 9 percent for Greece at its currently low rating. After taking account of liquidity gains for the euro as an international currency, as well as gains in exports to partners in stronger economic health, net costs to France and Germany could be close to zero.

The paper closes with a matrix relating each policy approach to its impact on the five countries facing debt difficulties, Germany and France, and the rest of the G7, showing an impressionistic index of the intensity and sign of the impact. The current policy programs, perhaps supplemented by market buybacks, show the most uniform positive effects if they can succeed. The option of exit from the euro would be negative for the troubled debtors (ballooning domestic currency burden of euro debt), negative for France for social-good reasons of high value attached to the single currency, and either negative or positive for Germany depending on whether avoidance of lender-of-last-resort burdens were more or less valuable than the loss of competitiveness from appreciation of a new currency if Germany and France were to exit.

Bruegel – Guntram Wolff (Bruegel) takes the opposite view on Greek solvency. Citing other Bruegel work, he considers Greece to be insolvent and notes that many economists believe it requires a 50 percent haircut. More broadly, he sees the euro area challenged by both a debt overhang and a need for price adjustment.

In the case of Greece, he suggests that debt haircuts need not be costly, especially if the primary deficit is zero and borrowing is no longer needed. Instead, Wolff sees the principal cost of sovereign debt haircuts as the impact on banking systems. By far the largest impact would be on the banking system of the country in question according to the most recent EBA stress tests. A 50 percent haircut for Greek debt would require only €25 billion in bank recapitalization funds, of which the financial assistance program for Greece already foresees €10 bn. Given the limited exposure of banks in other euro area countries, a haircut addressing Greek insolvency would cause relatively limited direct losses for Irish, Italian, Spanish, Portuguese, French and German banks. Wolff argues that the ECB would need to change its collateral policy and accept debt of a government that had defaulted in order to provide the necessary liquidity to the banking system.   He judges that Italy does not face a solvency problem.

Wolff then discusses further policy options, in particular with a view to avoid self-fulfilling crisis. The Blue (Eurozone guaranteed) / Red (not guaranteed) bond proposal (link: http://www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal/) includes joint and several liability. This would likely require a new EU treaty. He rejects the argument

that borrowing costs would be raised overall because greater liquidity would offset any higher interest costs. He further suggests that a big bang would be required splitting each current bond into blue and red, because the alternative of gradual issuance of blue bonds would introduce senior bonds, provoking legal challenges. Gradual introduction would also delay structural reforms.

On major EFSF expansion, Wolff argues that there is an internal contradiction because the large size that would be needed to address Italy (for example) would spur contagion to core countries, including France. He cites favorably a recent proposal of Gros to instead turn the EFSF into a bank with full access to ECB refinancing, placing debt management in the hands of finance ministers but ensuring a liquidity backstop.

Finally, Wolff considers euro breakup scenarios and argues that they would be prohibitively costly. A central concern of the current euro area remains, however, the lack of competitiveness adjustments and the increasing de-industrialization of the euro area periphery. Practically, debt under home country law would convert to the new home currency. But under current EU law it would be illegal to leave the euro without also leaving the European Union. For economic impact, he stresses the likelihood of massive asset-liability mismatches and resulting chains of bankruptcies. Once one country left, markets would attack the next one most likely to leave. So overall a euro area exit even by one member would have severe economic repercussions on the union as a whole.

Discussion – The general discussion revealed sharp division on whether a default by Greece would spread severe contagion to other Eurozone economies. One participant observed that even the PSI in the July package had triggered rising spreads in Italy and Spain. Wolff replied that instead the Italian spreads had risen as markets focused on domestic disagreements on fiscal action. Discussion of concrete steps to be taken emphasized the tension between a horizon of perhaps five years for deep institutional change such as creation of a Eurozone Treasury or development of Eurobonds, and the need for action in the short-term. The ECB was generally seen as the only entity capable of action in the near term. Some argued that the ECB was being overstretched, and that instead the EFSF could be used in more imaginative ways, such as insuring new bonds. It was also argued that it is not the comparative advantage of the ECB to conduct fiscal monitoring, yet currently it is in effect conducting shadow adjustment programs. The contagion to Italy has intensified the short-term problem. One participant feared that in the absence of an EFSF guarantee for banks, European bank equities would be far more severely depressed by the first quarter of 2012. As discussed below, the evolution of the simulation game played on day 2 of the conference did indeed lead to imaginative uses of the EFSF and more forceful measures to guarantee the banks.

Luncheon Speech – In a luncheon speech, George Soros (Soros Fund Management) argued that the lack of a common treasury had been an inherent weakness in formation of the euro. An embryonic Treasury, the EFSF, is not properly capitalized and its functions are ill defined. Tailored for the three small crisis economies, it is inadequate to support Italy or Spain. The German constitutional court decision subjects approval of future support to other states to Bundestag approval. The absence of concessional rates for Italy or Spain, and of preparation for possible default and departure from the euro by Greece, cast doubt on government bonds of other deficit countries and Eurozone banks with large holdings of these

bonds. The ECB purchase of Italian and Spanish bonds is not a viable solution; it did the same for Greece without lasting success. If Italy had to pay 3 percent in risk premiums, its debt too would become unsustainable. An orderly Greek default and exit from the euro may be necessary; a disorderly default could precipitate a meltdown like that following the bankruptcy of Lehman Brothers, this time without a Treasury to contain it. Even if catastrophe is avoided, pressure to reduce deficits will push the Eurozone into prolonged recession.

Four measures should be taken: bank deposits in Greece must be protected or else a run on banks would spread to other deficit countries; some banks in defaulting countries have to be kept operating; the European banking system should be recapitalized and put under European instead of national supervision; and government bonds in other deficit countries have to be protected. This will require a new treaty turning the EFSF into a full-fledged Treasury with the power to tax. Despite German public opposition, there is no choice because assets and liabilities are so intermingled that a breakdown of the euro would cause a meltdown the authorities could not contain. Default or defection of the three small economies would not mean their abandonment. The EFSF would protect bank deposits and the IMF would help recapitalize banking systems. As the bridge during time-consuming institutional change, with authorization from the European Council the ECB could fill the gap, indemnified from solvency risks. A solution in sight would help relieve markets. Because new arrangements would be on German terms, it would take eventual attitude change in Germany toward anti-cyclical policies to allow resumption of growth.

Simulation Game Day 2

The strategic game undertaken on the second day of the Conference was played in a large conference room at the conference center. About 50 people, stationed at tables labeled for each entity in the game, participated in or observed the simulation. The players included the ECB, the International Monetary Fund (IMF), market participants, commercial banks, political analysts and governments from Greece, Ireland, Italy, Portugal, Spain, France and Germany. Also participating were players representing the rating agencies and the US authorities. The game unfolded over several hours as participants voted their preferences on policy and in the marketplace. These choices were informed by the periodic infusion of new data from market participants on interest rates, bond spreads and other market developments.

The game drew on many of the insights reached in the earlier discussions and presentations but with a somewhat different focus. Whereas Day One concentrated on the broad political, economic and legal challenges to the stability of the euro zone, Day Two participants grappled with more immediate responses. Their goal was to address the deteriorating situation in the euro area caused by market pressure on several troubled economies. The participants ended up devising collaborative mechanisms to provide additional assistance to ailing countries of the euro area. The market reaction that unfolded in the game suggested that this approach could help quell the serious risk of contagion spreading from the periphery to the core of Europe.

The main feature of this innovative mechanism was a dramatic expansion in the lending capacity of the European Financial Stability Facility (EFSF) with collateralized financing from the European Central Bank (ECB). The scheme would make available substantial additional resources — depending on haircuts applied in repurchase agreements -- of between €3 trillion and €5 trillion through the new leveraged EFSF mechanism. The ECB played a pivotal role in the game in encouraging and assisting the euro area leaders to set up this arrangement.

The primary initial beneficiary of the new EFSF lending mechanism was Greece, which was provided €100 billion in new loans. Athens would use these funds to buy back its existing debt at a premium over current market prices, still reducing its existing stock of debt by considerably more than €100 billion. This was seen as easing Greece's solvency and budgetary concerns and encouraging the markets to offer it lower interest rates. In the game, the market reaction was to reduce these rates slightly. Diminishing risk for Greece was also seen as a significant contribution to overall stability in the euro area.

In a notable feature of the game, contrasting with some of the discussions of the first day, no concerns surfaced among the players about a possible breakup of the euro area. Lingering wariness over the economic outlook in Europe was widespread, on the other hand.

The reaction of the market players indicated some confidence that the new facility could effectively address the liquidity crises of the ailing countries. For all these positive developments, many of the players expressed concerns that they fell short of solving the euro area's long-term growth and financial prospects. Many players warned that even while the short-term financing and budget problems of Greece were eased, all the debtor countries needed to continue on a path of fiscal consolidation and structural reform in the years ahead. The new mechanism would leave unresolved the issue of how structural reforms could be fostered and conditionality imposed. Ultimately, it would therefore risk being tested again by the market. There were also concerns expressed about a possible political backlash against such an extensive new lending program, particularly in Germany, where previous expansions of ECB and EFSF lending have also raised legal and constitutional concerns.

A striking feature of the game, many players agreed afterwards, was that the devised solutions were not effectively communicated, including to the markets. The workings of the proposed leveraged EFSF facility had to be explained repeatedly by those playing ECB and IMF officials. In side meetings, participants from the euro area countries, often convening separately to discuss their possible decisions, sometimes had difficulty in arriving at a consensus on how to proceed. The ECB and IMF came forward on several occasions with key suggestions to address the problems faced in Europe. The ECB also contributed a small cut in interest rates, as well as unlimited long-term liquidity, as the crisis deepened in the first phase of the game. These difficulties illustrated the well-known challenge of achieving effective decision making in the euro area and communicating with the markets.

The large new lending facility was seen by some players as free money for errant countries without sufficient conditionality. But those devising and supporting the program argued that, on the contrary, it was mobilized to help countries that were on track in implementing their fiscal and

structural reform commitments in order to cope with the adverse effects on those countries of a slowing world economy and other exogenous factors. A lesson from the game was the need for the euro area to better define the framework for precautionary EFSF operations in support of countries with credible policies.

A team from the United States participated in the game and made a series of announcements including a maturity extension of the Federal Reserve's balance sheet, a third round of bond purchases, known as quantitative easing, and new dollar swaps with the ECB. These actions appeared to have little effect on the European situation. Players representing the United States also pointed out that the new EFSF lending mechanism was somewhat similar to what the Fed and Treasury had established in the depths of the financial meltdown in 2008-09.