To Default or Not to Default?

Daniel Gros* and Thomas Mayer**

This is indeed the question facing Greece and the European Union at present. One of the founding principles of EMU had been from the beginning the 'no-bailout' principle enshrined in the Treaty of Maastricht. Article 125 states clearly that neither member states nor the EU guarantees the public debt of any individual member state. This does not impede member states to grant each other assistance, but it is clear that in the ultimate instance national debt remains a national responsibility.

In April 2010 the member states of the eurozone decided to effectively 'bail out' Greece because they feared a collapse of financial markets if Greece had suddenly become insolvent and because they hoped that the tough measures agreed with the Greek government in exchange of the 110 billion euro EU/ECB/IMF programme could turn the country around. One year later the hope has largely evaporated as Greece has been unable to achieve the targets. It is becoming ever more apparent that the country, in the best of circumstances, would need years to transform itself to the point where it would be able to service its mounting public and external debts. To paraphrase a 2010 IMF Staff Position Note, such a restructuring, however 'undesirable', seems ultimately 'unavoidable' (Cottarelli *et al.* 2010).

However, the fear of a financial market meltdown in case of default remains. This fear seems to dominate policy makers' thinking, leaving them to provide the country with ever more public financing. In this contribution we therefore discuss whether the consequences of default have to be as dramatic as some claim (see, for example, Lorenzo Bini Smaghi, Financial Times of 30 May).

* The Centre for European Policy Studies (CEPS).
** Deutsche Bank.

We conclude that a debt restructuring in the context of a multilateral agreement among creditors, the debtor and EU institutions should be manageable. A 'second Lehman' is not the unavoidable consequence of a default, at least for Greece. Moreover, the low market price of Greek debt provides a way to avoid an outright default but still provide meaningful debt relief.

Introduction

Most EU officials and most government officials of EMU countries 'officially' reject any suggestion for a restructuring of the debt of Greece (not to speak of Ireland or Portugal). However, an increasing number of them seem to admit in private conversations or in background comments to the press that such a measure may eventually be unavoidable for at least one of these countries.

The arguments 'why' are by now well known: Greece, in particular, is unlikely to generate a sufficiently large primary surplus any time soon that would restore market confidence in its solvency and thus reduce its borrowing rates to levels consistent with socially acceptable debt service payments. But without market access, Greece (and other countries) will have to rely on continuing official support to refinance maturing debt. Rising financial exposure to the troubled countries will raise political resistance against further financial help in the countries granting the assistance, and continuing pressure for ever more austerity demanded in return for external assistance will raise political opposition against adjustment policies in the troubled countries themselves. In the end, political grass root rebellion, which has already started on both ends of the spectrum ('true Fins' and the 'indignants' on the streets of Athens) will enforce an end to either austerity or financial assistance and will thus trigger a debt restructuring.

Officials seem to realise that the road they are now pursuing leads to trouble. Should private lenders be 'bought out' completely by open-ended official funding of the troubled countries' borrowing needs, an

important precedent would be established for the future. Private investors could rely on public sector bailouts, even if they funded insolvent sovereign entities. The resulting 'moral hazard' would perpetuate excessive lending to profligate governments within EMU.

Those warning against a restructuring often make the following points:

1. A debt restructuring will be too costly for the community of EMU countries.
2. A debt restructuring is no substitute for the comprehensive economic adjustment required in the troubled countries.
3. Countries whose debt has been restructured will lose market access for a very long time.
4. A debt restructuring will create moral hazard for the EMU sovereigns and induce new over-borrowing in the future.
5. A debt restructuring of one country will lead to contagion of other countries and perpetuate the euro debt crisis.

We now turn to a more detailed examination of these five arguments. We concentrate on the case of Greece which represents the most acute situation, but we will not neglect other two GIP countries (Ireland and Portugal) currently receiving financial assistance.

A debt restructuring will be too costly for the community of EMU countries

The total public debt outstanding of GIP countries at the end of last year amounted to 624 billion euros, a sizeable amount but not very large relative to the total GDP of the euro area (6 percent). Greece alone accounts for about one half on this, or about 3 percent of euro area GDP. Table 1 shows the holdings of Greek public debt by lender. Apart from other foreign investors (which range from pension to hedge funds), the largest creditors were domestic banks, followed by foreign banks and official institutions (EU, ECB and IMF).

The item 'Other foreign investors' in Table 1, which includes hedge funds, should be able to absorb losses, since they are typically much less leveraged and more diversified. Of most concern is the exposure of the banking sector. Among foreign banks, banks in Germany and France have the biggest exposure to GIP countries (about 30 billion euros each). Again, these amounts are significant but not very large relative to the size of these economies. Exposure is concentrated on Greece. According to last year's CEBS (Committee of European Banking Supervisors) bank stress test, exposure to this country amounted to 12 percent of the Tier 1 capital of German banks (with exposure concentrated on Hypo Real Estate and the Landesbanken) and 6 percent of the Tier 1 capital of French banks. The stress test also showed considerable exposure of banks in Belgium (14 percent of Tier 1 capital) and Portugal (9 percent of Tier 1 capital) to the Greek government. Only part of the debt held by banks has been marked to market.

The single biggest exposure to the troubled countries is that of the ECB. The European Central Bank has bought bonds of these governments in the amount of about 74 billion euros and has lent the banks in these countries 319 billion euros against collateral of varying quality (Table 2). A 25 percent loss on the ECB's exposure to Greece (which would seem possible in the case of a 50 percent haircut on Greek debt and an existing 25 percent mark-down from face value for the assets held by the ECB) could cost the ECB almost half its capital (of about 80 billion euros). This loss would of course be dramatically reduced if in an orderly debt restructuring the Greek banking sector would be stabilised so that it could honour its obliga-

Table 1

Classification of Greek public debt by lender (in billion euros)

	2009	2010	2011 (forecast)
Total public debt	298.5	327.0	345.0
of which			
Domestic banks	41.8	63.0	58.0
Foreign banks	68.5	52.6	45.5
National central bank	12.0	15.2	15.2
Other domestic investors	24.7	11.6	11.0
Other foreign investors	151.6	106.1	95.0
EU/IMF assistance	0.0	31.5	78.0
ECB SMP (securities markets programme)	0.0	47.0	42.0

Sources: IFS; BIS; ECB; EU COM; Bank of Greece; DB Global Markets Research.

Table 2
The ECB's exposure to GIP countries (in nominal billion euros, end 2010–early 2011)

	Greece	Ireland	Portugal	Total
SMP (securities markets programme)	47	15	12	74
Liquidity	91	117	41	249
Emergency Liquidity Assistance (ELA) of the Central Bank of Ireland (estimated)		70		70
Total	138	202	53	393

Sources: ECB; DB Global Markets Research.

tions to the ECB. In this case, the ECB would only be affected by its direct exposure through the securities markets programme: SMP (and could lose 12 billion euros or 15 percent of its equity in our example).

All in all, we conclude that a debt restructuring of one of the troubled countries would not overburden the euro area economy. A 50 percent haircut of the outstanding debt of Greece (as suggested by many analysts) would cause lenders losses of about 170 billion euros. However, these losses would be distributed unevenly – with the Greek domestic banks and the ECB probably hit hardest – and some support by the stronger euro area governments (in the form of capital injections into weak commercial banks and the ECB) to avoid risks to the euro area financial system would probably be needed.

A debt restructuring is no substitute for the comprehensive economic adjustment required in the troubled countries

To be sure, debt restructuring would be no substitute for the comprehensive adjustment the troubled countries have to go through to achieve a primary surplus and restore growth. At the same time, debt restructuring would not eliminate the pressure for adjustment as market access could only be regained when budget balance and growth have been restored. But adjustment may be socially more acceptable when it does not involve the creation of high primary surpluses to pay off creditors, especially when the latter mostly reside abroad.

Sometimes it has also been argued that restructuring should come as a 'reward' when a country has achieved primary balance. Hence, as long as the primary balance remains in deficit, a restructuring should be avoided. However, with restructuring cutting the country off from new funding, the primary budget would be forced to balance immediately. Making restructuring conditional on the prior achievement of primary budget balance raises disincentives for timely adjustment for both the borrower and its lenders. They can rely on external funding the longer they delay the achievement of budget balance.

Countries whose debt has been restructured will lose market access for a very long time

The argument that countries whose debt has been restructured would lose market access for a long time cannot be dismissed easily. However, if the troubled countries were to reduce their debt ratios to levels more acceptable to investors, they would also be net payers to the market for a long time. The adjustment programme for Greece, for instance, envisages large primary budget surpluses beyond the year 2020. Thus, Greece is expected to refrain from new net borrowing for at least as long as countries that defaulted on their debt were cut off from market access. For instance, Russia, which defaulted in 1998, returned to the international market again in 2010. The form of a restructuring also determines the duration of forced market abstinence. An orderly process with active participation of creditors can help a country to return to the market sooner rather than later.

A debt restructuring will create moral hazard for the EMU sovereigns and induce new over-borrowing in the future

This argument contradicts the previous argument that a restructuring would cut off countries from market access for a long time. It also opposes the earlier argument that continuous bailouts would create moral hazard among lenders. More importantly, it ignores the effects of debt restructuring on lenders. The excessive build-up of debt in some EMU countries was only possible because lenders assumed that a country within the EMU could not become insolvent. If private sector lenders were now shielded by bailouts with public sector money, their expectations would be confirmed and the stage would be set for reckless lending in the future. In fact, exposing lenders to default risks is probably the best way to

impose discipline on borrowers. Hence, the pricing of default risks by the market and the resulting risk premiums on government bond yields would seem to be a much better instrument to punish countries for running unsound fiscal policies than the penalty system embedded in the Stability and Growth Pact. This applies in particular to banks, for which the risk weight attached to sovereign lending in the euro area is still zero. A restructuring would induce in particular banks to avoid accumulating too much sovereign exposure and would thus make a future sovereign debt crisis less virulent.

A debt restructuring of one country will lead to contagion of other countries and perpetuate the euro debt crisis

When the debt crisis erupted in Greece towards the end of 2009, markets quickly demanded higher risk premia on government bond yields of EMU countries with high deficit or debt ratios. In early May, markets even started to doubt the survival of EMU itself. Since then, policy makers have shown an impressive determination to defend EMU and have taken steps that appeared entirely impossible only two years ago. As a result, markets have regained confidence in the continuing existence of EMU and focussed on the economic fundamentals of individual countries. As a result of this and determined efforts by the government to rein in fiscal deficits, stabilise the banking sector and support growth through supply-side reforms, Spain has been able to regain the confidence of the markets. Similarly Italy and Belgium, which have very high debt ratios but have a sounder banking sector or followed more prudent fiscal policies than the troubled countries, have also been able to contain the risk premia on their government bond yields.

Debt restructuring in one of the troubled countries without doubt will induce a renewed widening of bond yield spreads of other countries with high debt or deficits. However, outside of the group of troubled countries, this is unlikely to lead to a cut-off of sovereign borrowers from market financing. More likely is that markets will continue to assess countries on the basis of their fundamentals. This may well lead them to expect a debt restructuring in Portugal when restructuring occurs in Greece, and it may induce them to price in a higher risk of restructuring in Ireland, but it is unlikely that they will expect the same to occur in Spain, Belgium or Italy. Moreover, the more information the authorities disseminate about the exposure of banks and other systemically important financial institutions to troubled countries and the better they prepare a recapitalisation where needed, the lower is the risk of contagion within the financial sector when a restructuring occurs.

Comparisons with the reaction of financial markets after the Lehman bankruptcy seem completely unwarranted. When it went bankrupt, Lehman had literally hundreds of thousands of derivatives contracts outstanding in practically every major financial institution in Europe. The Government of Greece, by contrast, is not the counterparty to significant amounts of financial contracts and the total net amount of CDS (credit default swap) contracts on Greek government debt outstanding is well known and amounts to less than 5 billion euros. Moreover, the senior debt of Lehman traded at a rather low discount until about a week before its collapse, which came as a surprise. The difficulties of the Greek government have been known now for more than a year and the market discounts on Greek debt indicate that the market is anyway expecting a default with a rather high probability.

Thus, it would seem to us unconvincing to reject a debt restructuring for, say, Greece, when all other arguments are in favour merely on the grounds that this would indiscriminately affect a larger number of other euro area countries or financial institutions. Rather than preventing necessary restructuring in an insolvent country it would seem better to prepare for it by establishing an orderly process, creating the best possible transparency on financial exposure, and pursuing convincing adjustment policies in other countries.

Conclusions

Our discussion of debt restructuring for the countries under the euro safety umbrella has shown that this may well be costly for individual entities (especially domestic commercial banks and the ECB), but can be digested by the private and public sector in the euro area at large if an orderly process and a high degree of transparency are established. Hence, it would seem to us dangerous to preclude such a debt restructuring under any circumstance. Such protection may well come at the cost of undermining the political basis for the EMU in both, countries giving and receiving assistance.

Public sector involvement in a debt restructuring is of course needed to prevent the failure of the entities

most exposed to losses from bringing down the entire financial system of the euro area. Public assistance for recapitalisation would probably have to focus on the banking sector in the affected country, the ECB, and euro area commercial banks heavily exposed to a loss of claims associated with restructuring. More generally, public sector involvement can help rebuild trust between creditors and debtors when such trust has been impaired by a default.

Moreover, the present low price of Greek public debt offers the chance to implement a market-based approach to debt reduction: a European institution (maybe the European Financial Stability Facility – EFSF) could offer holders of Greek debt an exchange into EFSF paper at the current market price. In the context of the ongoing stress tests banks would be forced to write down holdings in their banking book and thus have an incentive to accept the offer. The EFSF could then write down the nominal value of its claims to this amount and agree to an extension of maturities of its claims on Greece (at unchanged interest rates), provided that the country agrees to additional adjustment efforts (and asset sales). The difference between the refinancing cost of the EFSF and the interest rate it would earn on its claims on Greece could be in the order of 100 bps, thus providing a service fee and some margin for the remaining risk.

This approach can restore Greece's access to private capital markets in the longer run if two conditions are met:

- the remaining debt level must be sustainable at interest rates which incorporate a moderate risk premium, and
- the EFSF claims must not be senior to those of private bondholders – the EFSF support must be akin to an injection of equity into the country. This is the case for the existing loans under the Greek programme (and EFSF lending in general) but has been rejected for the new European Stability Mechanism. While the EFSF would concentrate on the exchange of the stock of bonds, the IMF would continue to fund any remaining fiscal deficits during the adjustment period.

With even shorter-term Greek debt now trading at close to 60 percent of its face value, our approach would lead to a sufficiently large reduction of debt at a reasonable cost for the private bond holders. An average discount of 40 percent in the bond exchange would push the debt ratio below 100 percent of GDP and require bond holders to write off some 140 billion euros. Close to full participation could be ensured if the country passes a 'mopping-up' law as already proposed by Lee Bucheit last year. Such a law would in effect create a 'statutory' collective action clause valid for the entire existing debt stock.

The ECB would need to participate in the exchange, given that it holds about one fifth of the stock of Greek debt. In order to save face and keep up appearances, the ECB would be offered a special bond with a very long maturity (say, 15–20 years) and a low interest rate. This bond would have the same present value as the EFSF bonds offered to private bond holders, but would avoid the realization of losses and the need for a recapitalization of the ECB.

Compared to a mere rescheduling, our approach would have the advantage of offering a much higher chance to put an end to the debt crisis. With contagion of countries other than those already under the umbrella now less of an issue, authorities should utilize this chance.

References

Cottarelli, C., L. Forni, J. Gottschalk and P. Mauro (2010), *Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely*, IMF Staff Position Note, 1 September 2010, SPN/10/12.