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Greece's
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*Too strict
conditions
do not work*



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The Netherlands and the European debt crisis

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Summary

Over the past 18 months, the interest rates for the government debt of Greece, Ireland, Portugal and Spain have risen to such levels that redeeming these debts has become problematic. This directly affects the Netherlands because it provided support to both Greece and Ireland via various channels.

Will the troubled countries be able to fully repay their debt? Policy institutions remain confident, but the premiums to insure the government debts of these countries show that the financial markets do not share this assessment. Certainly with respect to Greece, there is a risk that the country will not be able to fully repay its debt. If Greece's level of debt is indeed too high to redeem, continuing to require full redemption will be detrimental to the Netherlands, as this would negatively affect its growth perspectives. This will decrease the amount of debt repaid. Reducing the debt will prevent this and will therefore benefit all parties.

Who will pay the bill of such a debt decrease: the original creditors or the governments of the Euro area (and thus ultimately their tax payers)? As soon as it is clear that a troubled country is unable to fulfil its obligations, a decision on this issue is required. The longer this decision is postponed, the higher the proportion of the original debt re-financed by the emergency fund will become. Consequently, the proportion paid by the creditors will be lower, and the portion of the bill eventually presented to the governments of the other Euro area countries will increase. It will prove difficult to charge the creditors, however, as these largely consist of banks, insurers and pension funds. It is unclear whether all European banks will be able to bear such a loss. Also, there is a fear that restructuring will lead to a European banking crisis. For this reason, the European banking sector must become healthy again and a mechanism enabling the restructuring of government debts must be established.¹

¹ We thank Mark Roscam Abbing, Paul Veenendaal, Wim Suyker and Douwe Kingma for their contributions.

1 The tax payer is at risk

The financial crisis of 2007 – 2009 has developed into a government debt crisis. By late 2009, doubts relating to Greece's solvency permeated the capital markets. Subsequently, Ireland, Portugal and Spain became suspect as well. The fear that the European debt crisis would spread, causing problems within the European banking sector, was the key reason for granting support to both Greece and Ireland. Certainly with respect to Greece, there is a risk that the country will not be able to fully redeem its loans. The key question now is who will pay the bill if a country does not. One of the possibilities is that the original creditors of these countries will do so. These creditors include a wide range of banks, insurers and pension funds in the rest of Europe. This may cause serious problems for some of these banks, requiring support from their governments. Another possibility is for the debts to be transferred to the newly established *European Financial Stability Fund* (EFSF). This means that the creditors will have lost nothing – at the expense of the tax payer. A decision is postponed, partially in hopes that the problem will disappear naturally and partially based on the concept that postponement will lead to more information, allowing for a better decision. However, the question is: Is postponement free of charge?

Although the underlying causes of the crisis differ in each country (see the box *Problems differ between countries*), Greece, Ireland, Portugal and Spain were all confronted with a strong increase in the interest on their government loans. For Greece and Ireland emergency measures were required to save them from bankruptcy. Greece was granted a bilateral loan. The Netherlands are one of the guarantors of loans provided by EFSF², the European Commission³ and loans in the context of the IMF support programme.⁴ Furthermore, the government is exposed to any losses incurred by ECB on their government bonds purchases.⁵

Table 1 shows that the Netherlands have guaranteed an amount of 13 billion Euros so far, and committed to increasing these guarantees up to 69 billion Euros in the event of emergencies. Due to these measures, the Dutch government – and therefore the Dutch taxpayer – are fully exposed to the Greek and Irish credit risks.

² EFSF is a executive body of the governments of the Euro area. EFSF attracts money in the capital market, lending it to countries with a debt problem. Guarantees of the member states form the collateral for EFSF loans. The Netherlands provided EFSF a guarantee in proportion to its ECB share and a back-up guarantee amounting to its proportional share within the AAA rated Euro area countries. These AAA back-up guarantee will not be invoked until other non-AAA countries fail to comply with their guarantees.

³ The European Financial Stability Mechanism (EFSM) is a programme of the European Commission that serves to grant loans to countries with problem debt. The collateral is the European Commission's current account. The current account is the Commission's funding financed by the member states.

⁴ The IMF is an international financial institution helping countries with debt problems. The Netherlands lends IMF money based on a quota system. Redemptions to IMF loans are preferential to other redemptions; this means that the risk of non-redemption to IMF is small.

⁵ The ECB bought government bonds through open market operations and retains government bonds as a collateral for loans to commercial banks. The Netherlands is involved via DNB, one of ECB's shareholders. Any losses incurred by ECB on government bonds bought are converted into lower DNB dividends to the Dutch State via the ECB capital key. ECB buys the bonds at current market value. The current market value is lower than par value as it is based on partial redemption by Greece. ECB will incur a loss if the eventual redemption should prove lower than the current market value, which the market now considers realistic.

Table 1 The Dutch State incurs financial risks due to the sovereign debt crisis

	Potential			Committed		
	Total (bln Eur)	Netherlands (%)	Netherlands (bln Eur)	Total (bln Eur)	Netherlands (%)	Netherlands (bln Eur)
Bilateral loan Greece	80	5.9% ^a	4.7	80	5.9% ^a	4.7
IMF	250	2.7% ^b	6.9			
Portion for Greece				30	2.7% ^b	0.8
Portion for Ireland				22.5	2.7% ^b	0.6
EFSF	440	6.0% ^c	26			
Portion for Ireland				17.5	6.0% ^c	1.0
EFSF AAA back-up guarantee			24			
EFSM	60	4.7% ^d	2.8			
Portion for Ireland				22.5	4.7% ^d	1.1
ECB: Direct purchases	77.5 ^e	6.0% ^c	4.6 ^e	77.5	6.0% ^c	4.6
ECB: Repos with troubled countries bonds as collateral	pm	6.0% ^c	pm	pm	6.0% ^c	pm
Maximum exposure	907		69.0	249.5		13.4
(a) Distributed via ECB key excluding Greece.						
(b) Distributed via IMF quota Netherlands * % useable resources (useable resources are the country quotas that IMF can use for granting loans).						
(c) Distributed via ECB key excluding Greece and Ireland. The Dutch share increases when other Euro countries call upon the EFSF fund.						
(d) Distributed based on financial power, via NL 2010 GDP / EU 2010 GDP.						
(e) This concerns an open-end provision. Source: ECB ad-hoc communications on open market operations.						

Additionally, any default in payments from Greece or Ireland will also have indirect implications. Dutch banks may be confronted with problems due to the necessary impairment of bonds they own of these countries. Furthermore, banks in other European countries will be impacted, undermining confidence in the European banking sector. In that case, the authorities may have to support them in order to prevent the financial system from becoming disrupted. The result is the same: eventually, the Dutch tax payer foots a large portion of the bill.

Problems differ between countries

After the introduction of the Euro, the interest rate in Greece, Ireland, Portugal and Spain dramatically decreased. Borrowing money became cheaper, reducing the need for fiscal and financial discipline and increasing domestic demand. Unit labour cost in these countries became disaligned with the rest of the Euro area, creating deficits on their trade balances, which makes them vulnerable to a debt crisis. Banks, life insurers and pension funds in other European countries, such as the Netherlands and Germany, financed this debt, which in turn sensitised them to a debt crisis in Greece, Ireland, Portugal and Spain. The table shows the deviations in economic development between these countries and Germany and the Netherlands.

However, the direct cause of the debt crisis differs between countries. The Greek government had been overspending for many years, presenting an overly positive picture of its financial situation. Ireland and Spain were confronted with a real estate bubble. As a result, the banks that were financing this real estate ran into trouble and required support from the government. Furthermore, the labour markets in Portugal and Spain have problems adjusting after a recession. This causes unemployment to rise because temporary labour contracts are terminated, whereas the wages of permanent contracts hardly decrease. This leaves no margin for creating new jobs.

Economic development in Europe diverges strongly

	Trade balance % GDP)		Unit labour costs (base year 2000)		Unemployment (% labour force)		Real estate prices (base year 2000)		Government support for banks (% 2008 GDP)	
	2006	2010	2006 ^a	2010 ^a	2006	2010	2006 ^b	2010 ^b	Support ^d	Guarantees ^d
Ireland	-3.6	-0.3	123	128	4.3	13.6	181	118	5	198
Greece	-11.3	-10.5	121	134	9.8	12.2	178	177	2	1
Spain	-9.0	-5.5	120	131	9.2	19.8	220	205	2	4
Portugal	-10.7	-10.3	118	127	7.7	10.7	113	121	0	2
Germany	6.4	5.1	99	106	10.5	6.9	93	94 ^c	0	5
Netherlands	9.3	5.3	113	123	4.7	4.1	139	141	6	34

Source unless otherwise indicated: OECD statistics

(a) Unit labour costs for the entire economy 2010 Q4 estimate – Source: ECB statistics.

(b) Source: BIS Property Prices: <http://www.bis.org/statistics/pp.htm>.

(c) Relating to 2009.

(d) Support concerns recapitalisations and asset swaps, guarantees cover losses on assets. OECD calculations through 2010 Q1 based on IMF (2010), source: Schich and Levy 2010.

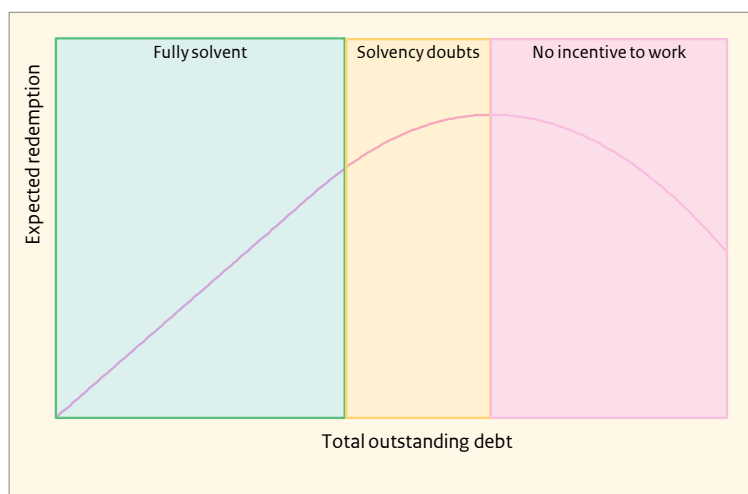
2 Too strict conditions have a reverse effect

It is in the Dutch tax payer's best interest that the troubled countries redeem as much of their debts as possible. This requires these countries to implement painful reforms paired with deep budget and spending cuts. The benefit of the necessity of such painful measures is that they incentivise such countries to prevent debt problems in the future. Additionally, such countries will benefit from institutional and economic reform, for instance within the labour market. However, the capacity of the troubled countries to redeem their debt is not unlimited. If the creditors of a troubled country raise the pressure too much, this may have a reverse effect. As this will cause the growth rate of such countries to drop to such extent that it results in a lower tax revenue available for redemption of foreign loans. Countries receiving support should have an opportunity for economic growth. How does this work?

There are three ways in which a creditor can make the situation worse by imposing excessive demands on the troubled country. In the first place, higher tax rates are virtually inevitable as part of a successful redemption plan. However, as tax rates become excessive, it is no longer interesting to work in the formal sector of the economy. People will work less, or take jobs in the informal sector thus evading taxes. Higher tax pressure does not work - beyond a certain point it will lead to a decrease in tax revenue. In the second place, a high debt ratio will undermine the investment climate. Private investors are less inclined to invest in a country with high sovereign debt, as this gives rise to fears that the government in question will skim the return on such investments through taxation in order to redeem debts. This is not about the current level of tax rates but stems from the risk of an increase in rates in future in order to redeem the debt. In the third place, excessive pressure to redeem the loans will stop the government allocating sufficient funds for projects that are required for growth, such as infrastructure projects. This is detrimental to growth prospects and therefore to the opportunities of paying back the current debt in the future. The political process in a country may reinforce this spiral. If requirements are too strict, this may cause social unrest and the public call to refrain from paying back loans. Full redemption of the loans therefore often comes at a considerable political cost to politicians in the troubled country.

In such a situation, debt forgiveness or easing the repayment conditions may increase the eventual redeemed amount, which benefits both the creditors and the citizens of the troubled country. Figure 1 is a graphic representation of this argument. Initially, the total redemption increases proportionally to the debt increase. At some point, doubts arise relating to the redemption capacity of a country. This is where higher debts will exacerbate the problem. Temporary support at high penalty interest rates is then a counter-productive measure, as this further increases the debt problem, reducing the expected redemption payments.⁶ In this context, the decision of the European government leaders of Friday 11 March to decrease the interest rate that Greece pays for its support loans by 1% and extend the loan redemption period by three years, is a sensible decision.

Figure 1 Expected redemption lower for excessive debt



From Table 2, it becomes clear that the governments in the troubled countries have already implemented incisive measures aimed at remediating their state finances. To the citizens of the troubled countries, this is already a far-reaching event, which does not promote confidence in the authorities and the European project. It is in the interest of the Netherlands to adopt a strict attitude with countries receiving support, but not excessively so. Being too strict will lead to lower redemption by these countries. This is detrimental to the Netherlands.

⁶ Introduced by Krugman (1988) as 'The Debt Relief Laffer Curve'.

Table 2 Troubled countries introduce incisive measures

	Greece	Ireland	Portugal	Spain	Germany	Netherlands
Budget reduction target	11% of GDP	10% of GDP	7% of GDP	8% of GDP	1% of GDP	3% of GDP
VAT	19% to 23%	21% to 23%	21% to 23%	16% to 18%	-	-
Number of civil servants	-20,000 during 2010	-24,750 during 2010	Vacancy stop, -5,000 teachers during 2010	9 of 10 vacancies withdrawn	-15,000 during 2010	-17,200 per year through 2013
Civil servant wages	13 th and 14 th month abolished	New civil servants -10%	High grades -5%, no promotions	2010 -5%, 2011 0%	Frozen during 2010	Frozen during 2010 and 2011
Labour	Limitation mandatory application CLAs	Min wage -12%, income tax bands -17%	-	Top rate income tax +2%	-	-
Retirement age	Women from 60 to 65 in 2010	From 65 to 68 in 2028	-	From 65 to 67 in 2027	From 65 to 67 in 2029	From 65 to 66 in 2020
Retirement cuts	Nominal amount frozen	New participants -10% pension avg -4/-7% (high -12%)	Nominal amount frozen	Nominal amount frozen	-	No or limited price indexation
Other	Sale of ports, railroad, mail and gas companies	7 bln pension fund money to emergency fund banks	Fewer municipalities, 2.6 bln pension fund money to the state	Sale of share in lottery, airport	Tax on nuclear energy and higher environmental levy	-

Source: CPB survey based on policy intentions of national governments and IMF evaluation

Financial crises can be self-fulfilling

A debt crisis always indicates a fundamental underlying problem. Somehow, the financial markets are no longer confident that a country is capable of redeeming its existing debts with its current macro-economic policy.

However, a debt crisis can be self-fulfilling. The doubts of the financial markets pertaining to a country's capability of redeeming its debts makes the country an unfavourable candidate when new loans are required. The interest rate increases, making it more difficult for the country to pay its debts. This is a self-fulfilling cycle of doubt. In other words, if most believe that a country will be unable to pay its debts, then this is indeed the case – even if the underlying problem in itself is perfectly solvable with solid and decisive policies such as spending cuts and institutional reform.

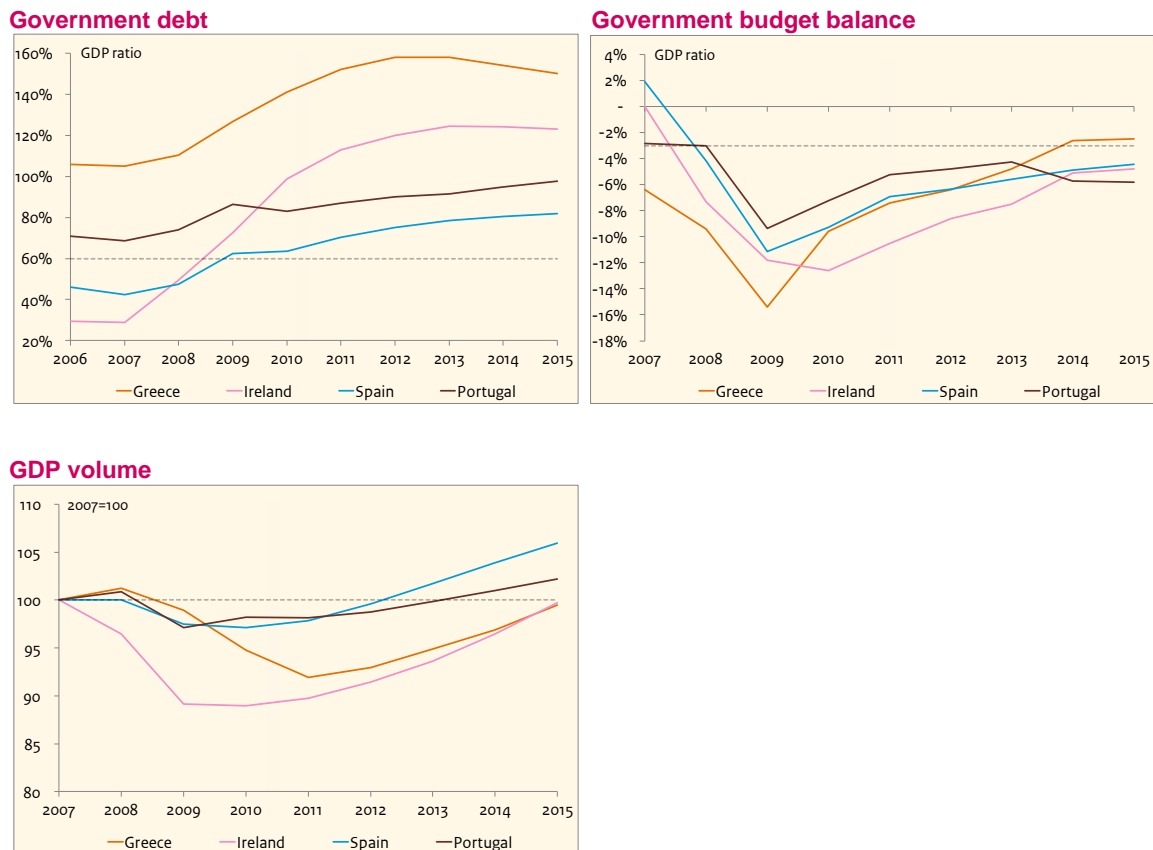
During the early phase of a crisis, the question is whether such a decisive policy will be able to restore the country's creditability. This is difficult to establish just after a crisis emerges. For this reason, it is in everyone's best interest to use short-term support in order to win time, enabling the country to turn the situation around. However, it must quickly become clear if buying time to restore confidence with economic measures is adequate.

3 Full redemption uncertain

Will Greece, Ireland, Portugal and Spain be capable to fully redeem their government debt? This question cannot be answered with certainty. Analyses of debt sustainability are highly sensitive to the assumptions applied. For the time being, policy institutions such as IMF and the European Commission presume that all four troubled countries will be capable of full redemption. However, economists such as Willem Buiter, Barry Eichengreen and Kenneth Rogoff have referred to the national debt of Greece in particular as unsustainable. The Brussels think tank Bruegel and the German economic research institute CESifo have come to the same conclusion in their respective analyses.⁷ Hereafter we will present a conservative estimate of the redemption capacity of the troubled countries. Furthermore, we will show the perspective of the financial markets on the risk of partial default of the debts.

The further development of these countries' debt burden depends on a number of factors, such as the current debt, the expected economic growth, and the expected revenues and expenditures of the government. Figure 2 provides an impression of these developments. For Greece and Ireland, the debt forecast is based on the incisive policy intentions as reflected in table 2; these intentions were not factored into the forecasts of Spain and Portugal.⁸

Figure 2 Greek national debt remains high in spite of significant spending cuts



Sources: IMF (2010a), Irish department of finance (2010), IMF (2010b), IMF (2010c).

⁷ See IMF (2010a), European Commission (2010a), Buiter (2011), Spiegel online (3-3-2011), Bloomberg (2-3-2011), Darvas (2011) and CESifo (2011).

⁸ These policy intentions are not available in sufficient detail for Spain and Portugal.

Figure 2 shows that the Spanish and Portuguese government debts will increase only gradually even in the absence of incisive budget cuts. Taking such plans into account, their debt ratio actually decreases. The same applies to Ireland, although the debt will stabilise at a rather high level (124 percent). In order to reduce the debt ratio to 60 percent of the GDP by 2035, Ireland will have to allocate 8.5 percent of its GDP to interest and net debt redemption. The tax rates in Ireland, however, are some of the lowest in the EU. This implies that debt might be sustainable as supplementary tax increases can be used to off-set additional set-backs.

A calculation based on the insurance premiums for hedging bankruptcy risk shows that the financial markets estimate the probability of Portugal and Ireland to be unable to pay their sovereign debt within the next five years at approximately 40 percent. For Spain this risk is estimated at 25 percent⁹. For these countries, government debt seems to be more sustainable than the markets estimate.

Greece is a different matter. Even when factoring in the additional budget cuts of which details have not yet become available¹⁰, the Greek debt will stabilise at 158 percent of GDP by 2013, according to IMF. In order to reduce the debt to 60 percent of GDP by 2035, 13.7 percent of GDP must be allocated annually to interest and net debt redemption. This will leave virtually no margin to absorb any set-backs, such as a higher interest rate. This calculation is based on a 5.5 percent interest rate. On the financial markets, the insurance premiums are in accordance with the government debt development as described above. In the perspective of the financial markets, it is improbable for Greece to be able to fully redeem its debts. They estimate the probability of Greece being unable to pay its debts within the next five years at 70 percent¹¹.

4 Choosing who pays

Supposing that Greece will indeed be unable to fully redeem its debts, what should happen from the Dutch perspective? Figure 3 indicates the possible course of a debt crisis. The upper part indicates the current state of affairs. Initially, support was offered to both Greece and Ireland in the form of the measures listed in Table 1. Support gives a country time to regain the confidence of the financial markets by means of economic reform. If it succeeds, the support operation is successful and the support funds can be gradually reduced and redeemed. However, if the reforms prove inadequate, part of the debt cannot be redeemed. In such an event, two parties may eventually bear the resulting losses: The supporting governments or the bond holders.

The first option is for the supporting governments to foot the bill. This implicitly or explicitly requires transferring money from the supporting European countries to the troubled countries - more loans, probably with a longer effective period and a lower interest rate, some part of which will eventually have to be forgiven. This sends the wrong message to the market, increasing *moral hazard*¹² for both the troubled countries and the bond holders. As soon as bond holders expect other European governments to provide support if one them cannot comply with its obligations, they will no longer take into account the possibility that the country in question may default on its debt when buying government bonds. Instead, they will assume that in such an event, the debt will be transferred to other Euro countries at the end of the day. In turn, this enables troubled countries to accrue more debt, sowing the seeds of a new crisis.

The second possibility is for the holders of bonds of the troubled countries to cancel part of their loan. In addition to citizens of the troubled countries, these bond holders include banks, life insurers and pension

⁹ This is based on a 30 percent hair-cut, implying that the country will pay back 70 percent of the loan. Source: Blundell-Wignall and Slovik (2011) and CPB calculations. This may include a liquidity premium due to the current low liquidity on the market for these insurances. The absolute risks will be marginally lower in that case, whilst the relative risks will remain the same.

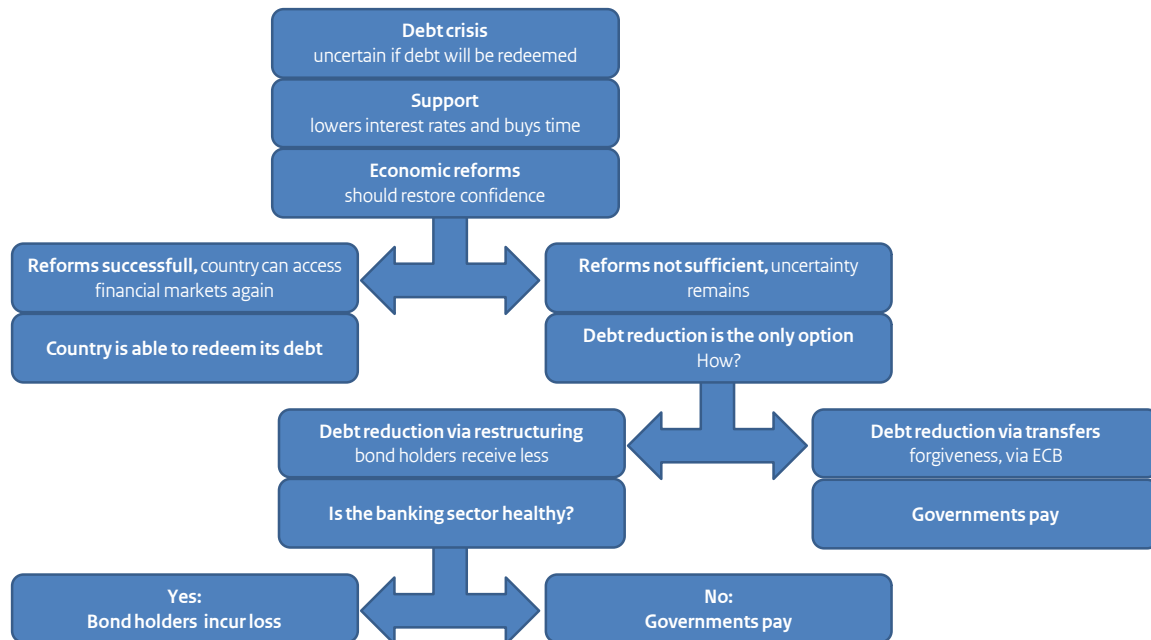
¹⁰ No details have been prepared relating to a structural cost saving of 5.5 percent of GDP through 2014.

¹¹ Moody's, the credit rating company, recently lowered Greece's rating referring to problematic tax collection, the required budget cuts and uncertainty relating to conditions for support after 2013.

¹² Moral hazard occurs when a party insulated from risk behaves differently than it would behave if it were fully exposed to the risk.

funds in the Euro area. Some of the losses are therefore incurred by the citizens of the Euro area due to devaluation of their pension as a consequence of losses on investments of their pension funds. Furthermore, there is a risk that some banks in the Euro area are not strong enough to bear the loss, and consequently enter into financial problems. This exposure of the banking sector can be both direct and indirect.

Figure 3 Diagram representing the outcome of a debt crisis



Direct exposure works as follows. A number of banks have considerable positions in government bonds of these countries and may therefore have a problem should it become clear that this debt is not fully redeemed. If the loss is sufficiently extensive, system-relevant banks will be compelled to turn to the government for support.¹³ From public details of European stress tests it appears that the Dutch banks have accumulated a total of 7.8 billion Euros in government bonds of troubled countries on the balance sheet - as shown in Table 3. This amounts to 9 percent of their core capital¹⁴ at that moment and implies a relatively limited exposure. Based on the details of all 91 participating European banks, the OECD¹⁵ calculated the direct effects of restructuring the Greek, Irish, Portuguese and Spanish government debts. The OECD concludes that the direct impact on the Netherlands can be classified as minor.

¹³ A system-relevant bank is a bank of which bankruptcy would lead to unacceptable risks to the stability of the financial system. During the financial crisis, the governments provided support to system-relevant banks in order to guarantee the stability of the system.

¹⁴ Core tier one capital in this context means the Tier One equity within the scope of Basel II.

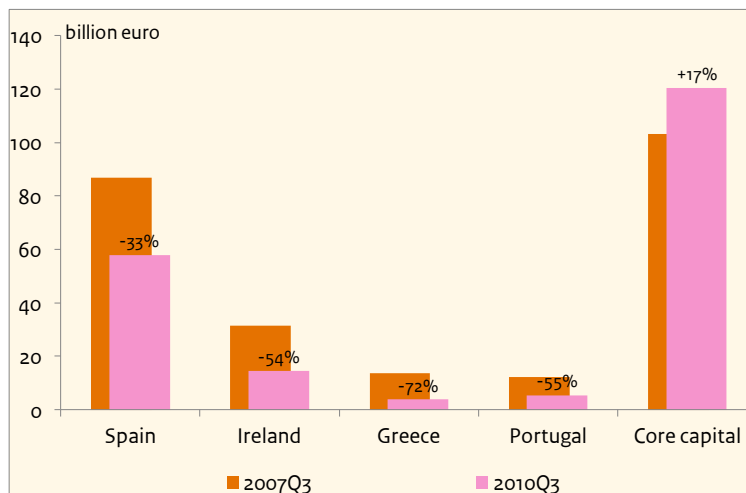
¹⁵ See Blundell-Wignall and Slovik (2011).

Table 3 Exposure of Dutch banks seems limited

	Ireland Bln Euros	Greece Bln Euros	Portugal Bln Euros	Spain Bln Euros	Total Bln Euros	Scope (% of Tier 1)
ABN Amro	0.2	-	0.1	0.5	0.9	6%
ING	-0.1	2.4	1.8	1.4	5.5	16%
Rabobank	0.1	0.5	0.1	0.2	0.9	3%
SNS	0.2	0.1	-	0.2	0.5	17%
Total	0.5	3.0	2.0	2.2	7.8	9%

Source: Stress tests European banks. Press releases ABN AMRO, ING, Rabobank, SNS 23 July 2010.
Amounts concern exposure relating to both the bank book and trading book. Please refer to footnote 22 for an explanation of this terminology.

There is an additional indirect effect. Restructuring also ensures that possessions of the banks other than government bonds will decrease in value, including commercial loans to troubled countries or to companies and banks operating in those countries. The implications of such a shock to the banks are therefore uncertain. This uncertainty exacerbates the impact on the European financial system of a government debt restructuring. If banks do not know each other's financial position after a shock, they will become reluctant to lend to each other on the interbank market. Banks with a weak liquidity position may then enter into a liquidity crisis, and subsequently have to approach the ECB for liquidity support or their national governments for recapitalisation. In view of the closely interlaced European financial system, snowball effects may cause such a shock to develop into a new financial crisis spreading through all European countries.¹⁶

Figure 4 Decreased exposures of Dutch banks to troubled countries

Source: De Nederlandsche Bank statistics k3/10, tables 5.6 and 5.9.

¹⁶ Banks in problem countries often have a substantial position in the government debts of their own country. This results in major direct exposure. If banks incur problems due to restructuring, the government is not capable of rescue operations. This leads to a high probability of bankruptcy of these banks, which may have major implications to both the troubled country and our banking sector. It is therefore sensible to have any restructuring preceded by establishing a support fund for banks in troubled countries. Both Ireland and Greece established funds designed to fulfil that purpose.

Public information on indirect exposure is not currently available. The international exposure of all Dutch banks combined decreased by 36 percent during the past 3 years, whilst their core capital increased by 17 percent. The exposure to troubled countries dramatically decreased, as is apparent from Figure 4.¹⁷ This figure reflects the combined exposure of all Dutch banks to all counterparties (governments, banks, companies and private persons) in the troubled countries as per late September 2007 and 2010.

Restructuring government debt therefore involves risks to the financial system. A framework enabling the supervisory body to take measures before a bank enters into bankruptcy is not available in most European countries, including the Netherlands – even two years after the credit crisis. Preparations for such a framework are in progress, both at a national and European level. This implies that the risks involved in restructuring are more extensive than is necessary. This means that also in this scenario the tax payer may eventually foot the bill. If a Euro country's debt is too high, there is therefore a choice between paying for support to the problem country, or possibly paying because support to the banks of the supporting country is required.

Buying up by the ECB necessary but not ideal

Support runs through two channels: Greece and Ireland are offered loans and ECB buys government securities of the troubled countries on the market in order to guarantee market liquidity. As a side-effect, these market transactions create additional demand for bonds of the troubled countries. This creates a bottom price for such securities, which translates into an upper limit to the interest payable by the troubled countries. The total value of the government bonds bought by ECB currently amounts to 77.5 billion Euros. It is inevitable for ECB to carry out these operations, as it is the only party with the proxy and operational capacity for such transactions. As long as politicians are unable to reach an agreement on these issues, ECB is the only party equipped to do this.

However, buying government bonds may result in a conflict with ECB's task of conducting independent monetary policy for two reasons:

1. For each decision, ECB must now consider the effect on the value of the government bonds purchased. For example, if ECB would decide to increase the interest rate, these bonds will decrease in value.
2. ECB bought these bonds on the market. If the eventual redemption is lower than the market price at the moment of buying, ECB incurs a loss. This loss will be divided among the member states in proportion to their share in ECB. This jeopardises ECB's independence as it is accountable to the governments of the Euro area for these losses. If the loss is substantial enough, it may have to apply for a capital injection. However, its very independence is crucial to its role in the monetary policy.

The ECB has repeatedly indicated its discontentment with the current situation. If the ECB incurs losses on these bonds, this policy has turned into a support operation without any political decision-making preceding its implementation. Resolving the debt crisis requires winding-up this position of the ECB and a mandate from the political arena to a different institution for carrying out such operations. A permanent emergency fund could receive such a political mandate.

¹⁷ According to the statistics of BIS (Bank of International Settlements), the total international exposure of all European banks decreased by 16 percent during the same period, whilst the exposure of European banks to counterparties in the four troubled countries decreased by 21 percent.

5 The pros and cons of postponement

The European government leaders are currently postponing a decision on who will eventually pay the bill when a country's debts prove too big. This means that the ECB is forced to intervene in order to guarantee the liquidity of the market – even if it is reluctant to do so. It is a tall order for politicians to have to explain their voters that they must pay for someone else's debts, even if it is in the interest of those voters. The bankruptcy of a neighbouring country or fellow member of a monetary union inevitably has negative consequences for these voters. This is not a specific European phenomenon. At the time of the Mexico crisis during 1995, the American Congress did not give the government permission to issue a 40 billion emergency relief fund. When Mexico required quick cash in order to prevent bankruptcy, the American government granted a 20 billion dollar loan from a fund¹⁸ of the Ministry of Finance that was not within the scope of the Congress' authority.¹⁹

Table 4 lists the pros and cons of postponement relating to the choice of who should pay the bill of excessive debt.

Table 4 Pros and cons of postponing restructuring

Pros	Cons
More information relating to sustainability of debt	Higher costs for the supporting country
Time to adjust banking regulation	Benefits the holders of short-term debt
Time to make the banking sector healthy	Recapitalisation of banks by raising external capital not possible
Time to set up a restructuring regime	Risk of high-risk behaviour of banks (gambling for resurrection)
	Lower economic growth of the troubled country

The first pro is that support buys time, enabling the country to regain market confidence with substantial economic reform designed to significantly reduce debt in future. However, as soon as it becomes clear that a country will be unable to fully pay-off its debts, offering long-term support will only result in postponing the inevitable at an increasing cost to the support providing country.

The second pro of postponement is that it offers the EU and the national governments time to improve banking regulation, in particular to introduce a legal framework enabling the resolution of banks before they go bankrupt, following the example of the 'special resolution regime' introduced by Great Britain in 2009.²⁰ This regime sets out how banks may be dismantled with minimal losses to society. The introduction of such a framework is currently being prepared at a national and European level.²¹

The third pro is that postponement offers time for improving the health of the banking sector. This involves new, credible stress tests reviewing the entire balance sheet of banks, irrespective of whether assets are held

¹⁸ This was the Exchange Stabilisation Fund, a fund designed to stabilise exchange rates.

¹⁹ Furthermore, the rescue fund included 18 billion dollars from IMF and 13 billion dollars from the Bank of International Settlements and other banks (commercial banks). The peso currency stabilised and the Mexican government introduced economic reform. Mexico redeemed 100% of its US loans in 1997.

²⁰ This type of legislation may be complicated from a legal perspective. Hüpkes (2003) refers to a decision of the European Court of Justice in 1996 – the Panagis Pafitis case – that supposedly limited the possibilities of effective settlement of banks, as expropriation before bankruptcy takes place may constitute infringement on the European Human Rights Declaration.

²¹ See European Commission (2010b), European Commission (2010c) and Ministry of Finance (4-3-2011).

in the banking or trading book.²² Banks that are not solvent must be forced to issue new equity to private investors. If they are not successful in finding capital, the supervisory body must force banks to restructure or accept recapitalisation by the government, with expropriation of the current shareholders as the ultimate consequence. Postponement also promotes a healthier banking sector as the capital levels of the banks will have more time to recover from the credit crisis. Higher capital offers banks a larger buffer with which they can bear losses on their claims on troubled countries. This prevents the government from having to provide support and the tax payer from having to pay for the costs retrospectively.²³ Banks are currently highly profitable, partly due to the low interest rate that the ECB charges the banks. However, this profit must subsequently be converted into higher equity levels. Prohibiting payment of dividend until achieving the required capital levels will contribute to quick accrual of equity. Quick accrual is essential as unsufficiently capitalised banks have an incentive to take excessively high risks.²⁴

The fourth pro of postponement is that it creates time to adjust the regulations and legislation in order to establish a legal basis for a restructuring procedure for sovereign debt. This involves having to undertake a number of steps as reflected in the box *Restructuring procedure*.

Restructuring procedure

Which problems should a restructuring procedure resolve?

- The *free rider* problem
Negotiations on debt reduction cost the creditors time and money. A restructuring procedure must therefore provide an opportunity to appoint a representative group of creditors negotiating for the entire group. The negotiation result must be binding to all creditors once a majority approves. If this is not the case, an individual creditor will prefer to not cooperate and wait until the claims of the other creditors have been reduced, free riding on the other creditors' efforts. This implies a lower total claim, and therefore a higher relative value of that party's claim.
- The *hold-up* problem
When the stake he holds in a bond issue of a problem country's debt is sufficiently large, a creditor may attempt to frustrate negotiations until all creditors of all other bond issues have come to an agreement. This creditor holding up negotiations has a strong position. A country only regains access to the capital market if all its debt is restructured. He will often be able to obtain a higher amount or better conditions than other creditors. There are some examples from the Latin American debt crises of so-called 'vulture funds' that were buying bonds during the restructuring process for that specific reason.

From 2013 onwards, the Euro countries aim to include collective action clauses (CACs) in their bond contracts. This is a step in the right direction, as this resolves the free rider problem. It only applies to new debts, however, and therefore does not solve the current problems. A solution for the current debt problems would be a European treaty change introducing a *Sovereign Debt Restructuring Mechanism (SDRM)*, as advocated by Gianviti (2010). If this is too radical, specific legislation tackling the above problems would be an option.

²² Bonds in the banking book are in principle held until maturity and therefore do not need to be recognised at the current market price. A large portion of the claims on troubled countries is therefore still recognised at nominal value in spite of a substantially lower market value. Stress tests with partial revaluations of the banking book provide a partial impression of the problems. Only a test including the government bonds in the banking book will offer the banking sector the possibility of restoring the confidence of the financial markets.

²³ Basel III requires higher capital buffers of banks, increasing the individual capacity of banks to absorb shocks. However, the stricter Basel III capital requirements will not become fully effective until 2019. Until that moment, the risk of a crisis is therefore higher than desirable according to the new standard.

²⁴ In literature this is referred to as gambling for resurrection.

The above-mentioned pros are offset by a number of cons. Support is used for refinancing the expiring debts of a country and financing the budget deficit. As long as support continues to be provided, a country's debt to the fund will increase whilst its debt to ordinary bond holders decreases due to regular redemption.

Another disadvantage is that short-term debt is not treated the same as long-term debt. Short-term debt holders can presume that they will receive 100 percent of their claim, as the support fund re-finances expiring debt. Holders of short-term debt therefore are strongly motivated to lobby for continued support. Ambiguity regarding the consequences of restructuring is therefore in their interest.

The third con is that the uncertainty relating to possible restructuring will remain in the market. As a result, undercapitalised banks cannot attract new external capital. No party will invest capital in a bank when it is plausible that this will facilitate restructuring the debt of troubled countries at the bank's expense. Banks can only increase their equity in such a case by adding the bank's operating profit to their equity cushions rather than disbursing it as dividends. This process, depending on the bank's position, may take years. If many banks are confronted with this problem, it may lead to a Japanese scenario featuring long-term low growth rates.

This uncertainty relating to possible restructuring will also affect the troubled country itself. The fourth con is that if a country's debt level is unsustainable, postponing restructuring means that the demand of full redemption is maintained. This is counter-productive as it reduces the incentive to work and to invest in the country. This decreases economic growth and therefore the possibility to pay back debt in the future.

Postponing the decision whether or not to restructure the debt of troubled countries and, if yes, the decision on who should pay the bill, is therefore not costless. Postponement prevents the wrong decisions being made prematurely. Postponement maximises the chance that all relevant information is considered. The eventual decision is therefore almost by definition a better one. However, postponement comes at a substantial cost. Gradually, an increasing portion of the costs is borne by the governments of the Euro area (and thus eventually their tax payers). In the meantime, a wide range of parties receive no incentives or the wrong incentives. Postponement therefore comes at a price.

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