THE EURO ZONE DEBT CRISIS: WILL IT BE POSSIBLE TO RESCUE EURO AT ALL? (instead of introduction)

In 1962 the then Commission of the European Economic Community (EEC) presided over by the German politician Walter Hallstein presented the first proposals for the creation of the European Monetary Union. On the basis of these and on the initiative of the President of France Valery Giscard d'Estaing and the Chancellor of the Federal Republic of Germany Helmut Schmidt, the European Council decided in 1979 to create the European monetary system. This plan acquired a definite shape in 1992 in the form of the Maastricht Treaty. Now, 12 years after the implementation of the system on 1 January 1999, the European Monetary System is on the verge of a precipice due to the debts of its member states. Greece alone has accumulated debts in the total amount of 98.2 billion euros in 90 banks which participated in the European stress test. Ireland and Portugal owe 52.7 and 43.2 billion to the same banks.[1] Besides, there are the debts to banks of the considerably larger euro zone countries, such as Italy and Spain. If the government loans of the countries which are struggling up to their ears in debt had been recorded in the balance sheets at the actual day rates, the equity level of the banks had been considerably lower and the banks would probably have failed the stress test.

We can raise the question here about the actual importance of government loans for banks. Government loans ensure the required liquidity for banks as government bonds can be easily sold at normal times, the more so as the European Central Bank accepts such bonds for security in the case of refinancing. On the other hand, interest revenue can be earned from bonds and this is of particular importance to such financial institutions where the proportion of deposits from customers is higher than the demand for credit as it often is in German savings banks and other cooperative financial institutions. The importance of government loans will increase even more in the future when banks will have to keep a mandatory minimum liquidity reserve in the form of such government debt according to the Basel III rules (new solvency requirements for banks).

While before the beginning of the debt crisis government loans were regarded as a relatively solid investment, it currently applies only to the emissions of a decreasing number of countries. Increase in government debts is approaching a risky limit and countries are increasingly threatened by insolvency, which will happen as soon as their credit risks are evaluated as increasingly higher in financial markets. Considering all this we have to emphasize even more the importance of overcoming the current debt problems as soon as possible.

Greece with its debt burden of 350 billion euros is at the head of the ranking of such member states of the European Monetary System which are threatened by national bankruptcy.

[1] (in German:) Handelsblatt 20.07.2011, p. 6

Apart from the different measures adopted at the crisis summit of 17 euro zone countries on 21 July 2011, three main models can be considered to ensure sustained endurance of the debt burden.

☛ The general public has often discussed withdrawal of Greece from the European Monetary System. At first sight this seems to be the easiest and also the most appropriate solution for many. But we have to take into account the drastic devaluation that reintroduction of the former Greek currency drachma would immediately cause. While it would increase the competitiveness of Greek economy, it would be of no use for the national exports as long as there are no sufficient industries which could produce according to the requirements of the world market, e.g. its own pharmaceutical or supply industry. On the other hand, products imported to Greece would become drastically more expensive. Devaluation would be particularly devastating since all liabilities of Greece have been denominated in euro which would increase the debt burden for many times in a moment. And then the national bankruptcy would be unavoidable.

The domestic consequences would also be as catastrophic. Drastic devaluation of drachma would destroy the bank deposits of the population and bring along the insolvency of numerous companies. Banks would be the first to suffer as their investments in government debt are approximately a double of their equity. Already an announcement of the reintroduction of the drachma would cause a bank run as people would want to withdraw their deposits in euros in time, which in its turn would cause instant insolvency of Greek banks (outflow of deposits from banks has increased already now).

Withdrawal of Greece would be no solution for the debt problem for the European Monetary System as a whole either. On the contrary – withdrawal of Greece would mean a huge shock for the euro zone and the related replicating or domino effect would have consequences that are comparable to an extensive fire. It would violate one of the basic principles of the Monetary Union and would have a long-lasting effect. It would make it possible to consider also the withdrawal of other countries from the euro zone, with consequences similar to those described above, and due to higher risks such speculations would increase the cost of borrowing in financial markets also for other countries struggling under the loan burden. Considering all these reasons it is absolutely necessary to settle the debt crisis within the euro zone.

☛ Experts of national economy prefer the method of cutting debts, i.e. debt restructuring (“haircut”).[2] Such a “haircut” would be extremely risky for Greece as financial markets “hold long grudges” so-to-say and do not forgive anything easily. According to the results of an German-Argentine joint survey which covers the

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[2] A figurative term “haircut” is used in English literature in that context as the hair will be also shorter after such a cut. The origin of such a term is unclear. It has only been used in the last two decades after occurring first in papers on financial markets published in *American Economic Review* in 1989. In the case of a “haircut”, the creditor gets, for instance, only 30 euros of its initial claim of 100 euros; the extent of the haircut is 70 per cent in such a case.

period 1970–2010 and 68 countries, *"Countries which do not repay their debts in due time, ...get a long-term and harsh punishment."*[3] The survey shows that even five years after using the "haircut" method the "punishing mark-up" (higher interest rate for risk) has only decreased by a half, i.e. the negative effect of debt cutting is expected to be rather considerable also in the shorter term.

The positive effect of the debt reduction model described is that after such an operation the main burden will remain on the shoulders of private owners of the government debt – above all banks, insurance companies and funds. We have to note, however, that after cutting the debts it will be necessary to decrease and therefore write off the value of such receivables in balance sheets of businesses sooner or later and this will reduce the profits and therefore the payment of taxes to the state budget. Thus this chalice will not pass from the taxpayers eventually.[4] As Greek banks are holding such bonds, they will bear such losses and they will presumably have to be rescued as institutions important for the system by injecting fresh capital, which in turn will burden the whole European Community.

☛ The third main model consists in the restructuring of debts. Holders of government bonds will have the opportunity to exchange their claims against a country which is deep in debt for bonds of a supranational institution. In the case of Greece as a member of the European Monetary System, the European Financial Stability Facility (EFSF) would be such a rescue fund[5]. If we exclude a combination with cutting debts, the euro zone rescue fund EFSF would take Greek government bonds over at 100 per cent of their nominal value. Private creditors would receive EFSF bonds guaranteed by euro zone countries, i.e. *de facto* eurobonds for these. Greek bonds which would now be held by the European rescue fund would be restructured into new Greek government bonds, adjusting their terms and conditions to the insecure economic situation of Greece. Continuing of these bonds would, however, force Greece to follow a policy of strict economy and budgetary discipline.

In order to contribute to at least partial relief from debt by such a restructuring of debts and in order to involve also private economy in the process, the debt restructuring should be combined with cutting debts by 20%[6] to 50%[7]. As this

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[3] Cf here: Cruces, Juan/Trebesch, Christoph >Sovereign Defaults: The Price of Haircuts<, Juli 2011, handelsblatt.com/link. – The authors studied 182 cases in total, involving 68 countries, where such countries defaulted on their payment obligations. They reached the conclusion that when the governments of the countries concerned borrowed from the financial markets again in the following period, they were so-to-say punished with higher interest rates which depended on the amount of the total debt and the extent of debt cutting.

[4] This particularly applies to banks which are fully or partly state-owned.

[5] European Financial Stability Facility (EFSF) which is planned to be replaced permanently by the European stabilisation mechanism (ESM) by 2013. The respective legal provisions should be amended first to allow EFSF to purchase government bonds.

[6] IIF (Institute of International Finance) has made its proposal for approximately such a percentage.

[7] The Technical Advisory Committee of the Government of the Federal Republic of Germany has requested the cutting of debts by approximately a half.

concerns Greek banks, they have to be supported with additional rescue measures. Cutting of debts will alleviate the situation of the European rescue fund and therefore the fund itself will be able to alleviate the situation of Greece which can decrease its debts and lower interest payment liabilities. The remaining debt of Greece to the European rescue fund EFSF can then be restructured – similar to the case described above – into new bonds with more favourable credit terms[8].

Rating agencies have let it be understood that they would treat debt cutting as a default and respond to it by reducing the evaluation of the financial situation (default-rating). As a consequence, the expenditures of Greek for obtaining funds from capital markets would still remain high and might even increase.[9] In order to avoid that, involvement of the private economy through bank taxes or other similar taxes could be considered instead of following the haircut method.[10]

If imposing bank taxes would concern only well-functioning banks and they would remain within affordable limits, it would be questionable whether it would be enough for considerable alleviation of the debt burden of Greece. Therefore bank taxes should be combined with so-to say "soft restructuring of debts". Two possibilities are considered. The first method would help to temporarily alleviate the situation of Greece, even if with respect to current payment obligations only. The terms of the restructured debts could be considerably extended, lower interest rates established and deadlines for the payment of interests deferred. The second method would consist in allowing Greece with credits from the European rescue fund EFSF to buy back its own bonds which are currently offered well below their nominal value on the after-markets. If holders of these bonds sold them, it would *summa summarum* alleviate the debt burden of Greece and relieve it from further interest payments and debt repayments.[11]

In conclusion we have to admit that there are no definite recipes for overcoming the debt crisis. Therefore it is not possible yet at the moment to assess the effectiveness

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[8] Here the terms of 15 to 30 years have been discussed for the loans. According to the decisions of the crisis summit of the leaders of 17 heads of state of the euro zone in July this year, the term will be extended from 7.5 years to at least 15 years and the interest rates will be lowered from 4.5% to 3.5%.

[9] In order to break the huge – actually irresponsible – influence of rating agencies which is particularly evident at times of crisis when the often unfathomable evaluations of agencies may lead to dramatic aggravation of the situation, the EU Commissioner for Justice Viviane Reding demanded the liquidation of such agencies. The German President Christian Wulff does not present such radical demands, however. He suggested that rating agencies should be made responsible if their evaluations cause significant financial damage. – It is questionable, though, how the claims for damages could be convincingly quantified to have grounds for their execution.

[10] As that would create the possibility to prevent rating agencies from increasing their evaluations of the credit risk.

[11] The question remains here surely about whether or not rating agencies would interpret such an action after all as forcing them to give up claiming the debts and would lower the evaluation of the financial situation as a consequence (default).

of the decisions adopted at the debt conference held at the end of July this year. Quite a few points will probably need to be specified and also expanded before starting their implementation.

Considering the risks described, the method of soft restructuring of debts has the best prospects to succeed in our opinion when combined with the simultaneous imposition of the bank tax. The reason lies in the urgent need to stop further aggravation of the debt problems of Greece in order to win some time that way for taking additional measures required for the achievement of sustainable economic growth. In the future, Greece will have to be able to bear its own debt burden and also to repay the debts in the long term. Here the issue is not so much about implementation of strict austerity measures as about the development of new competitive industries, with simultaneous fundamental enhancement of the private business environment. Above all, more legal certainty[12] and general cutting of bureaucracy should be considered – particularly with respect to foreign investments[13] –, also fighting against corruption and favouritism, opening of the currently regulated markets, privatisation of state enterprises, creation of a transparent and competitive taxation system[14] and also clear salary structures. In addition to these basic truths it is urgently necessary to expand mid- and long-term growth perspectives by expanding the existing and creating new cooperation opportunities with other EU Member States. Promising investment opportunities can be found in such areas as infrastructure, renewable energy (particularly solar technology in the form of photovoltaic cells), construction of power stations, development of cross-border networks, information technology, transport, telecommunications, waste management and tourism. For the financing of development programmes it is intended to increase the resources of EU Structural Funds and to direct the funds planned for Greece above all for the support of economic growth and competitiveness of the state. It is also possible for the European Investment Bank (EIB)[15] to alleviate problems related to the required co-financing if Greece is not able to pay its own contribution required.

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Manfred O. E. Hennies
Kiel / Warder, Germany

Matti Raudjärv
Tallinn / Pirita-Kose and Pärnu, Estonia

[12] Among other things, with land registers.
[13] For instance, issuing of activity licences is too complicated and time-consuming in Greece and fulfilment of contracts and agreements often uncertain.
[14] This has to be accompanied by strict fight against tax fraud.
[15] The European Investment Bank (EIB) is a EU institution which supports long-term investments.