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European Shadow Financial Regulatory Committee (ESFRC) (2015) : Escalating Crisis in the Eurozone: The Case for Conditional Debt Relief for Greece (Statement No. 40)

David Veredas
Universite Libre Brussels

Niels Thygesen
University of Copenhagen

Tom Berglund
Hanken School of Economics

Reinhard H. Schmidt
Goethe University

Franco Bruni
Bocconi University

See next page for additional authors

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Authors
David Veredas, Niels Thygesen, Tom Berglund, Reinhard H. Schmidt, Franco Bruni, Harald Benink, Kern Alexander, Santiago Carbo-Valverde, Rosa Lastra, and Clas Wihlborg

European Shadow Financial Regulatory Committee (ESFRC)

Research Report

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SAFE Policy Letter, No. 43

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European Shadow Financial Regulatory Committee (ESFRC)

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Policy Letter No. 43

SAFE | Sustainable Architecture for Finance in Europe

A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt

Tel. +49 69 798 33684 | Fax +49 69 798 33910
policy_center@safe.uni-frankfurt.de | www.safe-frankfurt.de

European Shadow Financial Regulatory Committee[1]

ESCALATING CRISIS IN THE EUROZONE:
THE CASE FOR CONDITIONAL DEBT RELIEF FOR GREECE

Statement No. 40

Frankfurt, June 29, 2015

Escalating crisis between Europe and Greece

We are in the middle of a deep crisis between Europe and Greece. The ongoing crisis was triggered by the reduced ability of Greece to service its debt after a substantial contraction in its gross domestic product in combination with the refusal of the European Central Bank (ECB), the European Stability Mechanism (ESM) and the International Monetary Fund (IMF) to pay out tranches of the rescue package in face of non-compliance with loan conditions.

In this statement the European Shadow Financial Regulatory Committee (ESFRC) is advocating a conditional relief of Greek's government debt based on Greece meeting certain targets for structural economic reforms in areas such as its labor market and pensions sector.

[1] Following the example of the U.S. Shadow Financial Regulatory Committee a group of European professors and other independent experts in the fields of economics, finance, law and the regulation of financial institutions and markets set up the European Shadow Financial Regulatory Committee (ESFRC). The ESFRC had its inaugural meeting in Brussels in March 1998, during which the Committee had a working lunch with European Commissioner Mario Monti.

The current members of the Committee are:
David Veredas (University Libre Brussels), Niels Thygesen (University of Copenhagen), Tom Berglund (Hanken School of Economics, Helsinki), Reinhard H. Schmidt (Goethe University, Frankfurt am Main), Franco Bruni (Bocconi University, Milan), Harald Benink (Tilburg University & Financial Markets Group (FMG), London School of Economics (LSE)), Kern Alexander (University of Zurich & University of Cambridge), Santiago Carbo-Valverde (Bangor University), Rosa Lastra (University of London & FMG/LSE), Clas Wihlborg (Chapman University, Orange).

The illusion of Greek debt sustainability

Holders of Greek sovereign debt are bound to face losses sooner or later. The position of the European institutions is that debt relief for Greece must not be part of an agreement to release remaining loan tranches. This position amounts to maintaining an illusion that Greece will be able to service its sovereign debt and reduce its debt overhang if it only implements a set of fiscal and structural reforms.

For Greece to be able to service its debt, maintaining its level relative to GDP, its growth rate must equal the average interest on its debt while the primary deficit is in balance. To reduce its debt burden growth must be increased further and/or a continuous primary surplus is necessary. Few observers believe that the Greek economy will achieve sufficient growth and fiscal discipline to maintain a sustainable debt level.

Challenges of implementing debt relief

The benefits of debt relief for the debtor are obvious, but creditors also have a strong interest in reducing the debt burden to a manageable level. A reduced debt service enables the debtor to increase investments because it permits outside and even cross-border financing of valuable projects based only on the project's expected return and risk. Furthermore, a reduced debt burden provides incentives for greater investments since the debtor may keep a larger share of the investment return.

But debt relief is hard to achieve. Sovereign debt problems are closely linked to fragility of the banking system. In the case of Greece, creditor banks and governments fear that forgiving debt opens the door to permissive behavior in other countries. There is a suspicion that increased scope of the Greek government to spend may not be used to enhance growth prospects.

Three questions must be resolved in order to structure debt relief adequately. First, which groups must accept losses associated with debt relief. Second, how much debt relief should be offered. Third, under what conditions should relief be offered.

There is great urgency in achieving a solution to the issue of who is going to bear the losses of a restructuring of the Greek sovereign debt. The three candidates are Greek banks and their uninsured depositors, private creditors (mostly international investors), and official sector creditors (ECB, ESM and IMF).

Debt relief, Greek banks and other private creditors

If a full-fledged European Banking Union were in existence, the Single Resolution Mechanism for banks, which has not yet been implemented in Greece, would lay out principles for allocation of losses of failing banks that cannot bear the losses on their holdings of Greek sovereign debt. A joint European deposit insurance system would have protected depositors in Greek banks.

Greek banks are already in deep trouble due to general withdrawal of deposits triggered by the heightened uncertainty concerning the future of emergency liquidity assistance by the ECB. They are not in a position to take substantial losses without failing.

Private investors faced substantial reduction in the value of their holding of Greek sovereign debt as a result of the debt restructuring in March 2012. The write-down facing the private creditors amounted to about 100bn euros. In addition, interest rates were reduced and maturities were lengthened.

Debt relief and official creditors

Official sector creditors (ECB, ESM and IMF) are now by far the largest holders of Greek government debt. Only they can provide for a substantial debt restructuring.

The largest creditor is the ESM with 144bn euros. The IMF has lent 48bn euros to Greece but is not willing to forgive debt to a European country that is richer than many other poorer countries with IMF loans. Thus, a European official authority would have to buy IMF's claims.

The ECB cannot offer unlimited support to Greek banks facing runs if there is uncertainty about the value of the collateral in the form of Greek sovereign debt. Thus, the ESM backed by eurozone member states seem to be the last resort. The ESM should take over Greek sovereign debt held by the IMF and the ECB. In order to retain the ESM's credit rating the eurozone governments would have to protect the ESM against substantial losses on its holdings of Greek debt.

In order for eurozone governments to accept the idea of standing behind the ESM there must be a clear understanding that the losses will be minimized. This problem can be addressed by conditional debt relief.

Conditional debt relief

Conditionality would imply that Greece would have to agree to a list of specific short-run actions to be taken during the next few years in order to improve economic growth. Examples could include a series of concrete reforms in the field of Greek's labor market and pensions system. Each year the ESM would monitor the progress made by Greece. Only, if certain pre-specified actions have been taken, the ESM would grant Greece, ex post, the planned debt relief. This will provide the Greek government with powerful incentives to implement structural reforms.

Our proposal is not one that grants Greece debt relief now. Only after having implemented a set of concrete actions debt relief would be given. However, the perspective of a debt relief in the future should be included as an integrated part of the rescue package that should be negotiated.