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Ester Faia

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Center of Excellence SAFE Sustainable Architecture for Finance in Europe
A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Grüneburgplatz 1 | D-60323 Frankfurt am Main

Tel. +49 (0)69 798 33684 | Fax +49 (0)69 798 33910
policycenter@safe.uni-frankfurt.de | www.safe-frankfurt.de

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Ester Faia

In a recent Geneva Special Report on the World Economy[1], Paris and Wyplosz have proposed a new plan for debt restructuring in the euro zone. The authors convincingly argue that debt restructuring is indispensable to maintain the euro area on a sustainable path. They claim that their plan can be implemented without free-riding of high-debt countries on low-debt countries and without future risks of moral hazard from high-debt countries.

The starting point of the plan resembles similar proposals invoked in 2011 and realized within the ESM: the idea, in a nutshell, is to transfer national debt to a large institution, that can leverage on the market and borrow (to cover and re-structure the national debt) at low cost. This time, the authors propose to have the ECB behind this form of debt re-leveraging and re-structuring. More specifically, the plan would require the ECB to acquire, at face value, a share of existing public debt and swap it into zero-interest perpetuities. As the ECB would pay interest on its obligations and would receive no interest on the perpetuities, it will make losses which, however, could be transferred to the individual countries. The losses could be repaid now and in the future with seignorage profits due to this county, therefore transferring the debt burden on to future generations.

The authors argue that the ECB is the best suited institution for this debt restructuring plan. They advance three main reasons for why this is the case: First, the ECB can mobilize large resources and borrow on the market at low costs. Second, central banks do not need to worry about their capital, as they have their credibility and, in principle, cannot default. Third, the ECB passes on profits, in the form of seignorage, to the euro area countries. Those profits can therefore, in discounted terms, compensate for losses. Therefore, low-debt countries would not need to pay for the costs of debt-restructuring for high-debt countries.

[1] Pierre Paris and Charles Wyplosz, *PADRE – Politically Acceptable Debt Restructuring in the Eurozone*, Geneva Reports on the World Economy Special Report 3, January 2014.

Rather, future generations of high-debt countries are obliged to do that. This should therefore eliminate free-riding. Finally, the authors argue that the plan could eliminate moral hazard by introducing some conditionality. For instance, if a country continues to accumulate debt, the ECB could transform the zero-interest perpetuities into an interest bearing debt.

Although well thought-out and sophisticated, there are at least three reasons why the plan proposed by Paris and Wyplosz seems politically unconvincing and therefore not superior to other proposals, such as the Redemption Fund proposed by the German Council of Economic Experts in the annual report released in November 2011[2], which in my view remains the best solution.

First, it is not clear that seignorage profits will be enough, in discounted terms, to pay for losses resulting from debt restructuring. The authors' calculations are based on normal growth rates, but many countries in the euro area have stagnant growth rates. Furthermore, losses could still increase exponentially, if a panic based speculation would occur.

Second, it is not clear why the plan should relieve, in a definite way, the low-debt countries from sharing the debt burden within the euro area. On a normal path of losses, one could imagine that interest losses can be paid by future generations' seignorage profits, but if speculation and risk of contagion occurs again, or if it becomes clear that profits are not enough to cover debt costs, all countries in the euro zone will again feel obliged to intervene exactly as it happens now (and especially when their banks are exposed to the debt issued by the ECB).

Finally, the conditionality clauses introduced to avoid moral hazard are not very different from the ones introduced, for instance, for the outright monetary transactions. It is not clear why now they should be politically acceptable to low-debt countries. Moreover, it is unlikely that the ECB will transform zero interest perpetuities into costly debt if moral hazard occurs, as this move might still cause market panic and crashes in the whole euro area. Hence, the conditionality clauses may not prove credible.

[2] Available for download at http://www.sachverstaendigenrat-wirtschaft.de.

In my view, the Redemption Fund remains the only politically acceptable and secure way of reducing the debt burden in the euro area while facilitating debt re-structuring. The reason is simple: it is based on the only economic guarantee that eliminates debt default and moral hazard, namely offering collateral UP-FRONT. When a country asks to transfer debt to some institution in the euro area, it should advance, up-front, appropriate collateral, rather than the mere promise of repayment by future generations. This plan is feasible, as many countries have collateral in the form of gold or public assets. It is politically acceptable, as advancing collateral, that would be used to repay debt in case of default, eliminates any risk that low-debt countries will be called upon to share the costs. It does not put the burden on future generations, as every generation has an incentive to restructure the debt rather than to loose valuable collateral. It can be carried out by another institution, so that the ECB can focus on monetary policy and be a lender of last resort only in case of emergency.

Unfortunately, the Redemption Fund plan was not favored by the country that would benefit most from it: Germany. This is why economists are still busy using their imaginations to propose alternative and complex plans.