The Greens | European Free Alliance
in the European Parliament

Green ECON Team

Rescue for Greece: A Green proposal for a comprehensive emergency response to the Eurozone Crisis

16th July 2011

Introduction

The Euro area is once again at the edge of an abyss. The Eurogroup leaders' inability to put forward a credible response to the crisis has as consequence that the situation is spiralling out of control. The rescues of Greece, Ireland and Portugal were all designed to buy time and prevent contagion spreading to Italy and Spain. That strategy has clearly failed. Moreover the failure of the Council and Eurogroup to stop public quarrelling, to meet and send a strong signal when the chances of collapse are acute, worsens the situation.

The current existential threat requires a systemic response. A restructuring of Greek debt is a necessary part of a far-reaching solution to the Euro crisis. In addition, interest rates and spreads must urgently come down, as the current trend will rapidly lead to a breaking point[1]. Postponing it will only increase the probability of a disorderly debt workout. A unilateral default could trigger financial panic and speed up a systemic crisis, but on the other hand the current approach based on case-by-case bail-outs and far-reaching austerity measures without debt restructuring is not an option either as in fact it increases the chance of a unilateral default. In all cases the logic of punishment is unfair and is not working and must therefore be avoided.

Only a combination of measures can limit shock and bring Greece back on track:

- budgetary discipline and economic reforms
- lowering interest rates
- bringing down the total amount of debt
- progressive taxation and on profits, private wealth and high incomes
- incentives for investments in future sectors as part of a Green New Deal for Europe

Such a combination of measures should aim at ensuring burden-sharing. A burden sharing is required to the extent that the current situation is the result of collective mismanagement. Greek authorities doctored their statistics (which the EU member state was aware of) and maintained a dysfunctional and corrupt tax system. The EU institutions failed to enforce the Growth and Stability Pact and prevent the building-up of an unsustainable level of sovereign debt in Greece. Private creditors did not apply due diligence and fuelled a credit bubble.

[1] On 13 July 2011, Italy had to pay a coupon of 5.9% for a five-year bond. Such a level represents a clear threat to the long-term sustainability of Italian public debt.

Researchers from the Breugel think-tank calculated[2] that, in the case of Greece, depending on the rate of economic growth, a primary income surplus of between 8.4% and 14.5% of GDP would be needed to bring the country's debts down to a level of 60% of gross domestic product within 20 years. At the same time, export-oriented and resource-rich Norway is the only OECD country to have achieved a primary budget surplus of more than 6% in the past 50 years. It follows that Greece, in addition to funding the budget, needs lower interest rates to service the public debt, and that action will have to be taken, with participation by creditors. The effects of the restructuring measures are already unbearable for the most vulnerable sections of the population, but the IMF and the EU are not pressing nearly hard enough for the wealthy to play a real part in funding the costs of the crisis. It is therefore imperative to reduce the Greek adjustment burden to a level which would be realistic with respect to historical standards, and which would take account of the domestic economy's structural patterns and therefore be grounded in the capacity-to-pay principle. In view of the country's history and institutional setting, we assume that Greece can pay interest on public debt amounting to 5% of GDP in 2011.

In the next 30 years, there should only be payments beyond this amount if the path of real GDP growth exceeds 2% per annum. The assumption is consistent with a very significant process of fiscal consolidation and would require under reasonable GDP growth assumptions a permanent fiscal surplus of around 3% of GDP in the next 20 years, which is already quite ambitious and would anyway require a massive restructuring of the Greek economy and very solid fiscal consolidation and discipline. In addition, a privatisation process would be useful in Greece in some sectors but it would not bring any immediate relief. In all cases a fire sale approach must be avoided as it would impoverish the Greek population[3]. A low-cost foreign-controlled privatisation process would further lower public support for the necessary reforms in Greece. Such a scenario would in any case allow the country to get out of the trap of the current debt-deflation spiral without cannibalizing the economy.

In addition to these benchmarks and in order to restore legitimacy and accountability, a comprehensive debt audit would be an important step in order to allow the Greek and EU legal system to sue those responsible for mismanagement and corrupt practices, reinforce the rule of law and ground public governance on the respect of fundamental rights. However, a debt audit process takes time which Greece does not have anymore. Therefore it is not the solution to today's crisis.

Following a first Green proposal of November 2010 for an orderly restructuring[4], the current proposal aims to achieve the following four policy objectives:

- **reduce Greece's economic burden**
- **ensure a fair burden-sharing between public and private creditors**
- **ensure Greece's access to capital markets**
- **allow enough time for re-launching macroeconomic fundamentals**

[2] Breugel paper available at: http://www.bruegel.org/publications/publication-detail/publication/491-a-comprehensive-approach-to-the-euro-area-debt-crisis/

[3] For an excellent example of the consequences of a badly-managed privatization process see the Paolo Manasse paper, *why privatization is not the panacea for Greece, http://www.voxeu.org/index.php?q=node/6592*

[4] *A comprehensive emergency response to the eurozone crisis,* available on line*:* http://www.greens-efa.eu/fileadmin/dam/Documents/Policy_papers/Emergency%20response%20to%20the%20Eurozone%20crisis%20-%20discussion%20paper%20-%20final%20doc%20EN.pdf

These objectives could be achieved by a pre-emptive exchange offer. Pre-emptive exchange offers basically consist of offering lenders the possibility of exchanging their outstanding claims (short term and long term bonds) against new bonds with lower interest rates, longer maturity (length of the loan) and/or lower nominal value[5].

Parameters of the exchange offer

At the end of 2011, the Hellenic Republic will have received IMF funding amounting to €21.5bn and bilateral loan disbursements of €56.5bn from EMU Member States. Assuming that all maturing Treasury bills will be rolled over during the second semester of 2011, Greece will also have the following stock of outstanding market debt:

Government bonds under domestic law €240.3bn
+ Government bonds under international law €17.9bn
+ Treasury bills €16.8bn
= Total stock of market debt €275bn + (EU and IMF debt = €78bn) = €353bn

We also assume that the interest rate of Greece's IMF loans will remain close to 6%, but that the coupon rate on borrowing from EMU Member States will be lowered to 4% in consistency with the last Eurogroup statement of the 11 July 2011. It is worth noting that an interest rate of 4% is still substantially more than the European Union charges on the multi billion loans under the Balance of Payments assistance facility of Article 143 TFEU that have been made available to member countries which have not adopted the euro. Hungary, Latvia and Romania are all paying a surcharge of only 0.05% on top of the EU's funding cost, which has varied between 2.375% and 3.625% since 2008[6]. The logic of "punishment" of partner countries in economic difficulty neither helps European cooperation nor makes economic sense. The countries under an EFSF/IWF financing operation are already subject to tough economic reform programmes. Therefore, an additional incentive through high interest rates is weakening these countries further[7].

---

[5] As N. Roubini has recently argued in an extensive paper (N. Roubini, *An orderly market based approach to the restructuring of Eurozone sovereign debts obviates the need for statutory approaches.* Available at: http://www.roubini.com/analysis/138863.php) there is strong theoretical and empirical evidence that potential market failures and externalities which allegedly prevent orderly restructurings can be resolved through pre-emptive exchange offers. If a debt swap framework is well designed and coordinated such a mechanism should be able to deal with the 'rush to exit', 'rush to court' and 'systemic risk' externalities, as well as the free rider and credit default swaps (CDS) claims-related concerns.

[6] The benchmark formula for calculating interest rates of borrowing from EFSF is the following:
The formula applied by the EFSF is the following: Effective Interest Rate = 1.2*(3-year swap rate + Margin (3% + 1% for any additional year) + Annualized Cost of Once-Off Service Fee around 0.15%). The 1.2 factor is explained by the over-collateralization requirement (EFSF can only lend 1euro for 1.2 borrowed). In practice it would mean that for a 3-year loan the interest rate would be a few basis points above 6% and for a 5 years loan around 8.8%. ´The crucial point (see below) is that this benchmark is not legally compulsory, it is taken from the method used for the Greek loan. The EFSF legal framework agreement says the following :

"The interest rate which will apply to each loan is intended to cover the cost of funding incurred by EFSF and shall include a margin (the "Margin") which shall provide remuneration for the Guarantors". If this margin is 0.5% for instance, instead of the 3 to 5% indicated in the EFSF that would mean a 3 year-loan of 3.5% and around 4% for a five-year loan.

[7] An exception should be made for Ireland which is refusing to end very low corporation tax rates. As long as Ireland does not accept at least reasonable minimum tax rates, an interest rate subsidy is hard to justify. Of course tax rates should allow some room for manoeuvre to compensate for location disadvantages.

Under the capacity to pay assumption of 5% of GDP to be adjusted further in function of the growth capacity of the economy and given a forecasted GDP of €224bn for 2011 the maximum amount that could be used for public debt interest payments would be €11.2bn. The 5% of GDP assumption is not overly generous taking into account that the Greek economy has to regain competitiveness through an internal devaluation.

Under these assumptions, we can determine how much interest Greece can pay to its private creditors in the years to come:

Total annual payment capacity €11.2bn
– Interest payments to IMF: €21.5bn · 6% = €1.3bn
– Interest payments on EMU loans: €56.5bn · 4% = €2.3bn[8].
= Cash available to other creditors (including private creditors and the ECB) €7.6bn

This €7.6bn will therefore be used as the driving parameter for interest payment of other creditors in the framework of the exchange offer following a 'menu approach', in which private creditors will be offered an exchange of their holdings of government bonds for one of the following three options:

a) 30-year Discount bonds with GDP warrants and EFSF principal guarantee
b) 30-year Par bonds[9] with GDP warrants and EFSF principal guarantee
c) Cash buyback at €43 for €100 of face value

Under this €7.6bn payment ceiling and assuming that after a workout the spreads will come down to a more reasonable level of 7%, the face value of the discount bond (a) would be €52 per €100 of original face value and its coupon 4%. The face value of the par option bond (b) will be €100 and the coupon 1.45%. The cash buyback option will pay €43 for a bond with €100 face value. (See annex for a detailed mathematical explanation).

The advantage of this 'menu option' is that it will accommodate the different investor profiles. Greek banks for instance, which in the current context rely heavily on ECB liquidity for survival, will certainly prefer the face value option as it would allow them under accounting standards (and in particular IAS39) to keep new bonds at face value on bank books. Other less constrained non-domestic investors will prefer a higher coupon or cash as they are already discounting the outstanding bond values at market prices. A combination of these two options should also accommodate the ECB which according to estimations of JP Morgan holds an outstanding notional amount of €50bn of Greek sovereign debt purchased at an average price of 80% and therefore purchased at around €40bn. The ECB can therefore afford a haircut of 20% and as it holds these bonds to maturity it can also use option b in order to limit any further write-down without booking losses[10]. In all cases the EU guarantee of the principal by means of a zero coupon EFSF bond, in addition to the incentive of a GDP warrant,

[8] Such an interest rate would represent a reduction of current rates of around 4.8% (already reduced from initial rates of around 6%) and therefore represents a restructuring. Moreover, a coupon of 4% would be in line with the coupon of option a. All in all, and in conformity with established practices the only preferential status granted will be to the IMF which will be considered as senior to all other creditors.

[9] A par bond is a bond with the same face value, in other words with the same principal being reimbursed back at maturity.

[10] Such measures should therefore be sufficient to protect ECB capital; but should these additional measures not cover all the losses the ECB should be recapitalised by its capital holders, in other words Member States

constitutes a clear incentive and will most likely push a massive majority of bondholders to accept the exchange offer as was the case in similarly structured operations in Uruguay after the 2001 crisis. The Uruguayan example shows in addition that after a well-designed exchange offer a country can achieve rapid access to capital markets at reasonable spreads. An additional feature that would ensure a close to 100% participation in the exchange offer would be that after expiration of the exchange offer, old bonds would no longer qualify as eligible collateral for refinancing operations with the ECB whereas the new bonds will still be eligible.

In contrast the Argentinean example during the same 2001 context (in which the country postponed a debt restructuring for too long) shows that an indefinite 'extend and pretend' strategy treating a solvency crisis as a liquidity crisis ends up in disaster and a disorderly default with massive and unpredictable costs.

Implementation of such a restructuring plan would lead rating agencies to downgrade Greece to "selective default". However, it is extremely difficult to avoid this outcome in any case. Even implementation of the much less ambitious "French Proposal", which would be excessively generous to private creditors, would trigger a downgrade to "selective default" by Standard & Poor's. In addition, the last statement of the Eurogroup has already acknowledged that a selective default is unavoidable. Policymakers of the Eurozone, who are responsible for the welfare of 331 million citizens, should not allow their actions to be constrained by the assessments of agencies that have contributed to the current crisis through their continuous misjudgements. However, as the International Swaps and Derivatives Association (ISDA) has recently stated, an exchange offer will not trigger a 'credit event' under CDS contracts[11].

It is important to underline that in the case of a 'selective default', the ECB would not be forced to stop accepting Greek debt as collateral as has been claimed by certain policy makers, given that according to the institution's status it has discretionary powers to accept any collateral even if rating agencies regard it as 'junk' - as is already the case for Portuguese and Greek sovereign debt. Therefore, the ECB has the ability to accept the new bonds swapped after the exchange offer as well as former ones before the expiration of eligibility as proposed above and in any case an exchange offer will require full cooperation and coordination with the ECB.

Such a framework establishes a baseline for any future EU debt workout process should adjustment programmes in other bailed-out Member States fail, as is currently the case in Greece, and will therefore reduce uncertainty and ring fence contagion effects.

It is evident that a debt workout mechanism is not an alternative to the systemic reforms required to re-launch fundamentals but it would provide the required timing and policy space for implementing reforms without creating an economic and social disaster.

---

[11] According to a Reuters interview of David Geen, chief executive officer of the International Swaps & Derivatives Association "From a CDS point of view, the proposals are all either an exchange or a rollover". "If it's voluntary, any rollover or exchange doesn't trigger CDS." this is consistent with ISDA definitions under which for restructuring and CDS contracts, a restructuring has to occur in a form that "binds all holders" in order to be considered a credit event. For more elements on this see: http://ftalphaville.ft.com/blog/2011/05/19/573111/par-don-me-what-was-that-about-greek-cds/

Complementary measures required to tackle the crisis

In any case, such a framework needs to be complemented with the following additional proactive EU measures already identified in the Green November proposals. France and Germany, who have to carry most of the rescue burden, should in particular use the Council meeting which has to decide on the new Greek package to propose a strong integration of economic policy, at least in the Eurozone: a genuine "European Economic Union" which should include inter alia the following:

Budgetary discipline and economic reform must be a horizontal principle to be followed and enforced while the next five guidelines should be respected.

First, the EFSF/EFSM financing capacities and scope must be significantly enlarged and include the possibility to buy bonds in secondary markets. In particular, interest rates charged must be affordable. The Framework Agreement governing the EFSF/EFSM allows for a reasonable interest rate (requiring only a margin above the rate at which EFSF/EFSM could obtain financing in the market) for a three or five-year maturity. The point is to avoid punishing any country, but instead allow vulnerable Member States to re-launch their macroeconomic fundamentals. This is only possible with realistic financial conditions attached to any bail-out. (See footnote 4).

Second, any EFSF/EFSM intervention in the framework of a comprehensive and far-reaching restructuring and downsizing of the European banking sector should encompass the rapid definition of special insolvency regimes when such regimes have not yet been set at national level. Special insolvency regimes should in particular allow Member States' authorities to intervene in financial institutions in order to restructure wholesale debt or convert it into equity while keeping or taking over operations such as deposits, savings and small business banking and transferring them to 'good banks'. In any case, a coordinated action plan for debt restructuring requires an *ad hoc* coordinated burden-sharing approach in order to avoid externalizing the total cost of exposure to insolvency to taxpayers and in particular taxpayers of vulnerable Member States. In this respect the special burden-sharing framework agreement for the North Baltic region provides an interesting benchmark of a coordinated *ad hoc* approach on burden sharing[12].

---

[12] As Dirk Schoenmaker explains in his Vox EU paper: *Burden Sharing, from theory to Practice,* available at: http://www.voxeu.org/index.php?q=node/5685. "A few large banks, such as Nordea, Swedbank, and Danske Bank, are operating throughout the Nordic Baltic region. The economies are very much interwoven through these banks creating potential contagion effects. A shock can spread swiftly through the region. Rather than changing the structure of the banking system, the Nordic and Baltic authorities have chosen to share the costs of financial stability reflecting the joint exposure to externalities. In August 2010, they agreed to a burden sharing scheme to make up for lack of proper diversification (Nordic Baltic Memorandum of Understanding 2010). Under this burden sharing scheme, the ministries of finance share the costs of a possible bank failure.
The burden sharing key is based on two components:

- the relative importance of the relevant bank in the countries as measured by asset shares (summing to 100%); and

- the supervisory responsibility for the same bank in the same countries (summing up to 100%)."

Third, in our view, conditions that equate to lowering minimum income and aggravating poverty and inequalities are unacceptable. Rebalancing public accounts should not be done at the expense of the most vulnerable; one should on the contrary ensure that those who most benefited from the debt-driven economy contribute most.

Fourth, there will be no healthy public finances in Europe without adequate taxation revenues as well as the build-up of a Fiscal Union: this requires a) a quantum leap in fighting tax fraud and evasion, b) a more adequate contribution of corporations (CCCTB, corporate tax rate harmonisation towards a minimum of 25%), c) updating and enhancing progressive taxation in order to cover all sources of revenues and in particular capital revenues d) significant progress on new fiscal resources for member States (FTT, energy and other environmental taxation) the latter potentially becoming own resources for the EU e) Eurobonds for Member States' sovereign debt refinancing in order to bring down spreads and tackle negative externalities. Project Bonds for financing 'a European Green New deal', in other words, the ecological transformation of the European economy. More specifically, if Member States comply with their adjustment path towards their medium term budgetary objectives and all 2020 commitments as well as correcting their macro financial imbalances as agreed in their Stability/Convergence programmes and National Reform Programmes, then they should be granted access to a premium/incentive which would be enhanced eligibility for 'EU performance' financing. This would/could include cohesion/structural funds as well as additional 'off-EU budget' substantial financing to be secured by a new financial instrument in the same vein as the Project Bonds concept as recently proposed by the Commission.

Fifth, an immediate and coordinated approach of National Supervisors is required to remove Credit Rating Agencies' ratings from binding financial regulation and prudential standards, as the German supervisors did already in the context of solvency rules on government bonds for insurance. Furthermore, investment funds should take out ratings from their investment guidelines. All financial actors must do their own risk assessments rather than relying on the three rating giants.

On all of this, urgent action is required by the EU Member-States in the Council, which retains exclusive decision powers in tax policy. Ultimately, the unanimity rule which still prevails in these matters - preventing any actual progress - must be replaced by qualified majority voting and co-decision with the European Parliament. This will require a Treaty revision which is the necessary consequence of the decision-making problems revealed during the crisis.

Beyond the current emergency, a long term approach requires comprehensive reform and enhancement of EU economic governance as a whole, in order to tackle the structural causes of the current crisis and in particular the broader stake of macroeconomic imbalances such as excessive private debt and excessive current accounts deficits and surpluses.

As we Greens see it, the current situation is a "make or break" moment for the future of Europe's political integration. We do not underestimate the destructive potential of the current financial, economic and social turmoil for Europe's societies. We need to resolve this crisis by combining the reestablishment of our public and private finances on sound bases *and* the investments in a Green New Deal that must enable Europe to be a pioneer in building a sustainable 21st century society. Failing that, Europe risks ending up as both unable to guarantee quality of life and social justice to its citizens and irrelevant as a global player.