

Tough talk but soft conditions?

Daniel Gros

16 March 2011

At the European Council on 11 March 2011, EU leaders agreed to the outlines of a new mechanism to deal with eurozone debt problems after the current mechanism expires in 2013. The mechanism is a continuation in the leaders' preference for 'tough talk and soft conditions'. This column argues that the package is merely the next step down the slippery slope of EU taxpayers sharing the burden with Greek taxpayers.

The main focus of the extraordinary meeting of EU leaders of March 11 was Libya – not the eurozone debt and banking problems¹ – but after this main topic had been dealt with, an informal agreement was reached on the eurozone debt issue. That agreement reaffirms a tendency that can be summarized as follows:

“No default will ever be allowed, but all bailouts will be preceded by tough talk.”

This general direction has now been clearly set. It will take a major disruption to make the EU convoy change track.

What has been agreed? More money at cheaper rates

The tough talk was the agreement on the renamed “Pact for the euro”, which contains a list

of desirable policy goals (national fiscal rules, more competitiveness, reform of retirement systems) but no means to implement them.

The soft conditions came in the form of:

- Restructuring the official debt of Greece for which the maturity was extended to 7.5 years and the interest rate reduced to 4.2% and
- Increasing the funding capability of the European Financial Stability Fund (EFSF) to the €440 billion originally foreseen (through an increase in the guarantees given by the AAA-rated countries, especially Germany).

These parts of the deal might be summarised as “more money at cheaper rates”.

Apparently it was also agreed that the EFSF might not only provide credits to countries that have lost access to the markets, but that it could also directly buy the government bonds of these countries. It is difficult to see the difference between primary market purchases of government bonds and providing credit directly to a country. This part of the agreement will be of limited value unless the condition (EFSF programme) is relaxed, as it well might be in future.

The trend: Tough talk and soft conditions

The meeting marks the third time that Germany has talked tough but then caved in when financial markets became nervous. The really tough talk that initiated the latest round of market nervousness came late in 2010, in the form of an

¹ See [“Remarks by Herman Van Rompuy President of the European Council at the press conference following the Informal Summit of the Heads of State and Government of the Eurozone”](#) and [Conclusions of the heads of state or government of the Euro Area](#), 11 March 2011.

Daniel Gros is Director of the Centre for European Policy Studies (CEPS), Brussels. This Commentary was previously published in a shorter version on VoxEU.com, 14 March 2011.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (www.ceps.eu) • © CEPS 2011

agreement between France and Germany. This agreement was then enshrined in the Conclusions of the European Council of 28-29 October, stipulating:

1. Financial support from the European Stability Mechanism will be subordinated to a prior 'sustainability test'.
2. New bond issues should carry 'collective action clauses' (CACs) which render it easier to negotiate a restructuring or rescheduling, should this become necessary.

This sounded tough, but it has now become clear that the 'sustainability test' will remain a paper tiger.

The litmus test of any such test will be Greece. Most independent observers and investors assume that the public debt of Greece today is not sustainable. However, the official story is completely different. The IMF/EU/ECB mission has already published its own assessment with a clear conclusion – there is no problem of sustainability.

This optimistic stance of the IMF/EU/ECB troika is not surprising. These institutions could not have started the rescue programme if they had not come to this conclusion.

Even apart from the specifics of the Greek case, it is clear that any rescue programme will be structured in such a way that it yields a sustainable path for public finances. To change the judgment that the public finances of the country in question are not sustainable after all would constitute an admission of defeat or, worse, the admission of an error in judgment. No official institution will ever admit this.

Even if the Greek programme goes off track, the official reaction will have to be: "There have been temporary problems, but a new programme will bring public finances back to a sustainable path".

Basis of the sustainability calculation

In Greece's case, the sustainability calculations of the IMF/EU/ECB are based on three simple assumptions:²

² A 'primary' budget surplus (i.e. not including interest payments on the debt) runs down the debt/GDP numerator, GDP growth runs up the denominator and interest payments run up the

1. The country can sustain a primary fiscal surplus of 5.5 % of GDP indefinitely,³
2. The growth rate of nominal GDP will be on average at least 3.5% and
3. The interest rate is at most 5.5%.

Under these combined projections, the critical debt/GDP ratio will start to decline around 2013.

Problems with the sustainability calculation

But there are three problems with this rosy calculation.

1. Most observers would of course doubt that the Greek body politic can sustain indefinitely a primary surplus of 5.5% of GDP. But this is what the Greek government promises; the Troika's sustainability assessment thus accepts it as an assumption.⁴
2. Similar doubts apply to the interest rate assumption (at most 5.5%). It is highly unlikely that private investors will buy bonds carrying such an interest rate.

The key issue here is a bit technical. According to the leaders' informal agreement, new bonds issued after 2013 would contain collective action clauses. These CACs are baked-in contractual conditions that make rescheduling easier. Since 'rescheduling' means 'partial default' from the investors' perspective, CACs are worrying to private investors – even more so since about half of Greek public debt is 'official' (i.e. own by the troika) and all of this will be senior to private debt.⁵ In plain English, this means that official debt-holders get to jump to the head of the re-

numerator. Sustainability means that the debt/GDP ratio doesn't grow forever.

³ Greece went through a significant fiscal adjustment during the early 1990s and recorded a positive primary balance between 1994 and 2003. Yet in terms of magnitude, the largest surplus reached only 4.3% and it stayed above 4% for only four years (see Cinzia Alcidi and Daniel Gros, "The European experience with large fiscal adjustments, 28 April 2010 (<http://www.voxeu.org/index.php?q=node/4949>).

⁴ Note that in 2010 Greece paid about €14 billion in interest on its debt, which corresponds to about 6% of Greek GDP.

⁵ See Daniel Gros (2010), "The seniority conundrum: Bail out countries but bail in private, short-term creditors?", 10 December 2010 (<http://www.voxeu.org/index.php?q=node/5891>).

payment queue if things go wrong. Private investors who think all this through – and who do not share the Troika's faith in the three assumptions – will demand an interest rate that compensates them for the probability of rescheduling losses.

3. The agreed size of the post-2013 Greek programme may well have to increase until almost all Greek public debt will have been refinanced by the ESM.

Given that the interest charge on the existing €110 billion programme for Greece (based for now on bilateral credits, but later to be rolled into the new facility to be called the European Stability Mechanism, ESM) has been lowered to below 5.5%, the interest assumption has also received official approval. And based on the logic discussed above, private investors will shy away from Greek debt and the ESM will have to take up the slack.

It is thus likely that the size of the Greek programme will have to be increased post-2013. Since Greek public debt already amounts to over €300 billion, the size of the ESM will have to increase after 2013, as the Greek package alone is likely to require about 60% of its financing capacity.

But this is not the end of the problems.

Once most Greek public debt has become official debt, a whole new game starts. At this point restructuring of private debt is no longer an option – the private lenders will have already backed out. The collective action clauses that were so cleverly included will be irrelevant. From this point onwards, the ESM can only restructure its own claims on Greece.

Restructuring in this situation would mean European taxpayers taking the hit in terms of longer maturities and lower rates. At that point, expect more of the same, i.e. tough talk and soft conditions.

Conclusion

On March 11th, the European Council has once more decided to kick the can down the road. They failed to think through the consequences of their actions from the perspective of the markets and they failed to think through what their decision will mean for the options they will face in the future.

Having come this far, it becomes very difficult to change direction. The best our leaders can hope for is that the road will take a decisive turn for the better and that the new 'Pact for the euro' helps them avoid future accidents.