

COUNCIL *on* FOREIGN RELATIONS

Center for Geoeconomic Studies

POLICY INNOVATION MEMORANDUM NO. 50

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From: Robert B. Kahn
Re: *A Paris Club for Europe*

Europe's strategy for solving its debt woes has the problem exactly backwards. A gaping hole in Europe's policy response to date is its unwillingness to reduce excessive levels of corporate, bank, and sovereign debt accrued during the global financial crisis and its aftermath. This debt has had a corrosive effect on investment and confidence, contributes to deflationary pressures, and undermines the public's trust in its economic future. Yet European leaders have not definitively addressed this challenge, hopeful that payment deferrals and an eventual return to growth will allow countries to outgrow their debt. This policy has produced a temporary improvement in market access at the cost of longer-term sustainability, contributing to an anemic recovery that is insufficient to address extremely high unemployment rates. A lost decade looms. A comprehensive, predictable, and rules-based program of debt reduction for over-indebted countries in the periphery of Europe can break the cycle of low growth and rising debt. Though there are many ways forward, one promising approach comes from the Paris Club, the informal group of official creditors that provides debt relief to low-income countries conditional on strong economic performance.

THE PROBLEM: GROWTH, DEBT, AND THE DOOM LOOP

In the four years since Greece first approached the International Monetary Fund (IMF) for a bailout, the periphery countries have been at the epicenter of the crisis. In response, Europe created rescue funds, eased monetary policy, and made substantial structural reforms to labor and product markets. As a consequence, Europe has moved beyond the series of crises and emergency weekend meetings that dominated the last several years. Backed by strong policy support from the European Central Bank (ECB), capital has flowed back into the debt of periphery countries. However, it would be a mistake to assume that the crisis is resolved. The outlook for growth—at around 1 percent through 2015—remains below trend and far too low to meaningfully reduce crushingly high levels of unemployment, especially youth unemployment, which exceeds 35 percent in Spain, Greece, Portugal, and Italy. As the sense of crisis has receded, the pressure for ambitious solutions has dissipated. Yet opinion polls show a growing dissatisfaction with Europe's course, and May's European parliamentary elections delivered a strong message of voter impatience with current leaders and their policies.

The pressing challenge for Europe is to restore growth before markets and voters again lose confidence in the reform process.

One of the central lessons from past crises is that high levels of debt can be a substantial and sustained drag on growth. In recent years, European governments have seen explosive increases in their debt ratios. In some cases, this reflects large fiscal deficits (e.g., Greece and Portugal); in other cases, the costs of supporting national banks played a significant role (e.g., Ireland and Spain). Low growth contributes to balance-sheet stress for banks and corporations, which in turn exacerbates financial distress—a “doom loop” between sovereigns and their banks that will damage growth. In the near term, ECB support ensures that these countries retain market access, but at the cost of higher future debt. Over time, rising debt service costs will exact a price in terms of confidence, reduced cross-border investment, and fragmented credit markets that will be particularly damaging for smaller, non-systemic borrowers across the periphery of Europe.

The sharing of costs across the union would break the doom loop. Yet a defining feature of the European policy response to the crisis has been concern over moral hazard and resistance to the notion that Europe would become a “transfer union.” Creditor countries—led by Germany—consequently have insisted that the mechanisms through which fiscal union would be achieved—e.g., eurobonds and fiscal transfer, or a full banking union that shares costs of bank restructuring—can only come at the end of the reform process, if at all.

Rather than acknowledge that the legacy debt has to be reduced to make current policies sustainable and create incentives for new investment, countries are forced to shoulder the burden of that debt with the uncertain hope of future debt relief. This presents two problems. First, it is highly uncertain that debt relief offered through undefined future interest-rate reductions will be adequate to restore debt sustainability. Second, the overhang of debt in effect subordinates other investors—including private investors—to official creditors.

There is no single percentage of debt relative to gross domestic product (GDP) above which a country is definitively insolvent. That threshold will vary across countries based on a range of economic, political, and social factors. But resolving the debt overhang in the periphery will require acknowledging that it will be nearly impossible for these countries to grow their way out of existing debt levels. There would appear to be increasing acceptance of the need for debt relief, but an inability, at least for now, to discuss it.

GREECE IN THE VANGUARD (AGAIN)

Nowhere is the corrosive linkage between debt and growth more on display than in Greece. Two years after its debt restructuring, the government had a successful return to markets, issuing a five-year bond at 4.95 percent. Investors' interest was supported by a reach for yield and a view that a short-term bond issue will be paid before the current moratorium on interest payments expires in eight years, rather than an improved sense of Greece's long-term creditworthiness. Such optimism may be short-lived, and policymakers may soon need to acknowledge that substantial further debt relief is needed. Greek public debt even after restructuring is around 175 percent of GDP, and in the IMF's low-growth scenario sees little or no improvement over the next decade. Greece is not alone. Throughout Europe, corporate debt is high and rising, while the European Central Bank-led banking assessment at the end of October will lead to additional costs of cleaning up the banking system. Ultimately, the responsibility for fixing corporate and bank balance sheets will fall on national governments. A contentious public debate may refocus investor attention on the unsustainability of current debt levels.

PARIS CLUB LESSONS

It is an unfortunate reality that over the last thirty years the world has had a great deal of practice resolving international debt crises. Though the circumstances differ, one common theme runs through the official responses to the developing-country debt crisis of the 1980s, the East Asian financial crisis of the 1990s, and the Great Recession. In addition to the implementation of new policies to reduce the risk of future crises, each case required a solution to the debt overhang in order to achieve a durable return to growth.

Fortunately, there is an effective model for dealing with a debt overhang: the Paris Club, an informal group of official creditors that has met since 1956 to deal with payment problems of emerging market debtor countries. For countries in crisis, the Paris Club provides rescheduling of sovereign debt owed to official creditors. Though the Paris Club's operations, geared as they are to low- and middle-income countries under IMF programs, may seem ill-designed for the large, complex industrial economies of Europe, three of its principles should be central to the European approach.

First, the Paris Club has a set of rules for the terms of restructuring based on the countries' income and debt level and are known in advance. In practice, the scale of debt relief will depend on a case-by-case assessment of the financing need of each program. Second, Paris Club restructurings are conditional on a proven record of performance under an IMF program. In the European context, there is an unfortunate stigma associated with IMF programs and conditionality, but nonetheless making relief conditional on performance is essential to address legitimate moral hazard concerns. The third principle is seniority for new lending and for trade finance. The Paris Club sets a cutoff date and the restructuring, as well as any future restructuring, will apply only to debt originally contracted before that date. New lending is therefore senior to old debt, in practice, which creates an environment that encourages capital to return. If this framework extended to Europe's periphery, confidence and incentives for new lending would be strengthened.

WHAT EUROPE SHOULD DO NEXT

With the release of the banking assessment and stress test toward the end of October, uncertainty about the effects of debt relief on banks is no longer an excuse for inaction. Europe needs to begin negotiations this year on a rules-based approach to official-sector debt relief, in which countries meeting firm conditionality would be assured of adequate (and predictable) relief. This approach would have the following elements: countries would receive a cutoff date and debt acquired before that date would be eligible for restructuring; restructurings would be tranching; and assistance would be conditional on policy performance, including structural reforms, continued progress toward macroeconomic balance, and programs for restructuring over-indebted corporate sectors. Though it is difficult to quantify the effect of reducing debt on the European economy, some estimates suggest that the resultant rebound in investment could raise European trend growth by up to one percentage point.

Critics will argue that debt relief is unnecessary when maturities have been extended and where additional concessions could be offered in the future if needed. That argument fails to be convincing, as the current approach creates uncertainty about whether adequate relief will be given, which policies the country should implement, and if austerity will someday end. Further, as seen in the case of Greece, long-term official debt does not impose market discipline on private lenders (though it does mean that new private debt will be short term, exacerbating the risk of future runs).

European leaders are understandably concerned about the costs of setting precedents when dealing with the crisis of the moment, as well as implementing a crisis-management approach associated with low-income emerging markets. But the costs of inaction are growing too large. Europe needs a Paris Club for European debt. Call it a consultative group if need be; hold it in Berlin, Amsterdam, or Brussels. The sooner these rules are established, the sooner Europe will see a return to growth.

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