Expert view on the euro crisis: Time for Plan B

What began as a sovereign debt crisis of individual countries has since escalated into a serious threat to the stability of the entire euro area. Divergent interests as well as differing opinions as to the appropriate policy response for the euro zone have led to a gridlock of opposing political stances. As these confrontational positions have become entrenched in the current crisis, the heads of state or government have so far only managed to agree on a "Plan A", which boils down to the pious hope that the crisis-stricken countries Greece, Ireland and Portugal might somehow soon see their way clear to repaying the financial assistance accorded to them by the EU member-states.

Compounding the problem, the European Central Bank (ECB) has resisted a monetary solution, seeing the sovereign debt crisis instead as a merely fiscal problem. Given that Plan A looks highly likely to end in failure, the present stalemate is open to the double danger of ending either in an unlimited bail-out or an uncontrolled break-up of monetary union.

Unlimited joint liability of the euro area would be the natural consequence of further growing indebtedness of the stricken countries coupled with their inability to adequately refinance their debt in the financial markets. This would inevitably lead to ballooning government support packages from the Community and disproportionate burdens on the financially sound countries. Such an outcome would not only jeopardise fiscal discipline, it would also give false incentives to the markets. Sooner or later the mounting financial strains on the fiscally strong countries are bound to unleash a political backlash there against monetary union.

The euro area could disintegrate even faster in the event of an uncontrolled sovereign default and exit of a country from the euro area. Such a process could be triggered by a stalling economy in the vulnerable countries reinforced by a contracting consensus on the need for reform. This would be exacerbated by doubts about the solvency of other countries, which would translate into higher interest rate spreads on their government bonds.

In view of the nightmare scenarios outlined above, the survival of European monetary union is a so much more obviously desirable option from Germany's point of view that it is now imperative to overcome the present gridlock into which the European policymakers have manoeuvred themselves and to do everything possible to ensure the long-term stability of the euro area.

The logic underlying our proposed Plan B is the conviction that a partial sovereign debt waiver is essential to restoring Greece's financial stability. Bondholders should take a cut of around 50 per cent on their outstanding Greek government bond portfolios. At a stroke, this would slash Greece's debt-to-GDP ratio from 160 per cent to roughly 106 per cent. The rating agencies would probably classify such a haircut as a credit default. In order to ensure the stability of this debt restructuring process, it should therefore be combined with an offer to exchange Greek sovereign bonds for securities issued by the European Financial Stability Facility (EFSF). This would mean that every Greek government bond with a nominal value of 100 euro could be exchanged for an EFSF bond worth 50 euro. The outstanding volume of Greek government debt would consequently be transferred to the EFSF's portfolio.

In order to maintain the incentives for reform in the crisis-ridden countries, the EFSF, working within the framework of the IMF/EU programmes, could stagger the debt remission process over time rather than granting it in full at once, and make it conditional on Greece meeting specified reform targets. Unlike Plan A, this solution would obviate and thus bypass the rating agencies' assessments as banks would then hold EFSF securities rather than Greek government bonds in their portfolios. Under this Plan B the ECB could be given the option of swapping its holdings of Greek bonds at their purchase price for EFSF bonds. Another advantage of this Plan B would be that speculators would not make any windfall gains. By contrast, under Plan A (and other variants of a "voluntary" exchange) they would recoup 100 per cent of the value of bonds which they bought at a hefty discount. The sole alternative under Plan B would be for them, at the end of a mandatory holding period, to swap their holdings of old Greek government bonds for new Greek bonds not underwritten by the EFSF at a discount of 50 per cent.

The drawback of Plan B is that banks that have invested heavily in Greek sovereign bonds would require special support. This applies first and foremost to Greek banks. The EFSF could be mandated to provide the necessary capital injection (amounting to about 20 billion euro), although funds for recapitalising Greek banks are also included in the IMF/EU programme. Another potential risk of Plan B is that it might trigger a chain reaction that could spill over to other vulnerable euro-area countries. This would not pose a big problem for Ireland and Portugal as they will be fully funded by the EFSF for a number of years. Similar debt restructuring schemes could be envisaged for Ireland and Portugal. Spain and Italy should concurrently step up their current fiscal retrenchment and adjustment programmes and, at most, apply for a contingent credit line from the IMF to avoid being dragged into a downward spiral. Ultimately, the danger of contagion can only be banished by resolute and common action by the governments of the euro zone and the ECB.

Over and above the immediate policy responses, a sustainably viable regulatory framework should be instituted for the euro area featuring a permanent crisis resolution mechanism. While the European Stability Mechanism (ESM) is a step in the right direction, it gives the European Council far-reaching discretion and thus suffers from much the same credibility problems as the Stability and Growth Pact. Credibility is currently an extremely rare resource in the euro area and can only be regained by putting in place the right institutional framework.

The authors of this paper, Peter Bofinger, Lars P. Feld, Wolfgang Franz, Christoph M. Schmidt and Beatrice Weder di Mauro, are the members of the German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*).

First appeared in: Frankfurter Allgemeine Zeitung, issue 161 of 20 July 2011, page 10