JOHN THORNTON, Professor of Global Finance and Head of Bangor Business School, outlines the scale and impact of the Eurozone's sovereign debt write-offs.

Banking on a chink of light

John Thornton

The policies needed to bring an end to the Eurozone's sovereign debt crisis are clear: a combination of sovereign debt write-offs; bank recapitalisations; European Central Bank (ECB) support for the banks and sovereign debt markets; medium-term commitments to fiscal discipline; and "structural reform" – cuts in labour and other business costs to restore competitiveness and growth.

Unfortunately for private creditors, these policies have important linkages, meaning that, in some cases, sovereign debt write-offs will have to be very large indeed.

In some countries, the sovereign has all but lost access to capital markets, and cutting spending and raising taxes are only serving to worsen economic conditions and fiscal deficits. The solution is for fiscal adjustment to include a large write-off of sovereign debt. Fortunately, this process has begun. The debt exchange offer tabled by the Greek Government in February 2012, if accepted by private creditors, will imply a cut of up to 53.5 per cent of the principal bond value, and a net value reduction of 75-80 per cent when reduced coupon payments on the new bonds are taken into account.

While sovereign debt write-offs are necessary, they have adverse consequences. Because European banks hold so much debt, the write-offs will weaken many and possibly bankrupt some. To avoid a contraction of money and credit and an associated economic meltdown, European Governments should provide public funds to assist with private bank recapitalisation. Doing this will raise countries' sovereign public debt-to-GDP ratios, meaning only very large debt write-offs will bring the debt burden down to a level where growth-enhancing policies will have a chance of working. This will mean lasting austerity and deep economic recession, likely to generate social protest and disorderly debt defaults, such as happened in Ecuador in 1999 and Argentina in 2002.

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Although Eurozone leaders have finally endorsed the view that recapitalisation is necessary, the amount under consideration is too small, and the insistence that banks first have to try to raise the capital themselves is likely to force them to contract their lending. To avoid a credit crunch, banks need to be given immediate access to the resources of an enlarged European Financial Stability Fund (EFSF). Moreover, as the EFSF has been called upon to backstop sovereign debt markets to avoid contagion, it presently lacks the resources to support the scale of recapitalisation likely to be needed.

The most encouraging policy development relates to ECB operations. Eurozone leaders and the President of the ECB seem to have reversed positions on the involvement of the ECB in supporting banks and sovereign debt markets. The ECB finally realised that central banks have a lender-of-last-resort role, acknowledging that the recent agreement by most EU Governments on a new Fiscal Compact gave it room for manoeuvre to support sovereign debt markets. The results are plain to see: massive ECB liquidity support to banks has facilitated their ability to refinance debts and participate in sovereign bond markets, reflected in a sharp fall in sovereign bond yields.

Of course, sovereign debt reduction is not enough to restore capability: countries need to be put on a growth footing – made to be more competitive. The most important "reform" in this regard is to reduce relative real wage costs. Staying in the Eurozone means adjustment by driving down wages through the threat or fact of unemployment. In some respects, this is probably the greatest remaining challenge for Eurozone policy makers because the scale of the likely resulting social disorder is so unpredictable. In the short term, real wage cuts also worsen the recession and governments need to be given some additional room for manoeuvre on the fiscal front, if only to be able to provide a minimum social safety net.

So is Europe's sovereign debt crisis nearing its end? No, but at least there is light at the end of the long, dark tunnel.

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