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After the Stress Test, Deal With the Debt

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OVERVIEW

Bottom Line: The European Central Bank's (ECB) recent asset-quality review (AQR) and stress test of eurozone banks was an important step. But restarting growth requires stronger macro policies if Europe is to avoid a Japan-style lost decade. That includes a more concerted effort to deal with the sovereign debt overhang that is a threat to consumption, investment, and growth.

In my recent Policy Innovation Memorandum (PIM), I argue that the overhang of debt is a critical constraint on growth, and call for debt relief for Europe's periphery. Why now? Partly, I expect debt issues will return to the fore over the coming years as growth stalls, adjustment fatigue increases, and spreads on periphery sovereign debt rise again. In addition, many of the critical policy debates in Europe were sidelined while awaiting the ECB-led AQR and stress test of the major European banks, which was released at the end of October. Supporters hoped that a credible stress test, and the positive market reaction that resulted, would represent a turning point in the crisis and "jump-start" the European economy. "I definitely think the banking crisis is behind us," said Dutch Finance Minister and Eurogroup President Jeroen Dijsselbloem after the release of the report. Such optimism is misguided and dangerous.

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The AQR and stress test constitute a serious effort to address the capital shortfall and restore confidence in the financial system, but they do not address all concerns. The review sets the stage for the ECB to emerge as the single supervisor and regulator for Europe's major banks, an important—if incomplete—step toward banking union. This effort, however, will not jump-start lending or get Europe growing again. Without growth, how confident can we really be that the crisis is over? Absent more supportive policies, the banking sector cannot regain its health, capital will remain inadequate, and a year from now the stress test may well look unconvincing. In that regard, I agree with Gavyn Davies: the exercise is a "necessary, but far from sufficient, step to fix the low-growth, low-inflation condition that has become the norm in the European economy."

EUROPE'S THREE ARROWS: THE JAPANIFICATION OF EUROPE

Concerns about European growth are a growing weight on markets. At the recent International Monetary Fund (IMF) and World Bank annual meetings, there was widespread talk of the risk of "Japanification" of the European economy, meaning a prolonged period of underperforming growth and low inflation. Though there was no consensus, I came away convinced that Europe needs its own version of Japan's Abenomics—its own "three arrows":

- *Monetary policy.* ECB sources have been quoted as suggesting that bolder action, including the purchase of government bonds (quantitative easing, or QE), could come before the end of 2014 or at the January 2015 meeting. A narrow majority (Germany is not alone in its opposition) now seems to recognize that current policies are inadequate, but it appears unlikely that the ECB will

be proactive or clearly articulate its commitment to QE unless growth and inflation numbers get significantly worse. Forward guidance on policy, as much as the purchases themselves, will provide the real boost in the European case.

- *Fiscal policy.* Europe needs a more countercyclical fiscal policy, with greater spending by the surplus countries providing the demand that is missing as the periphery countries continue to consolidate, but it is hard to imagine such coordination on fiscal policy any time soon. The IMF expects European fiscal policy to be broadly neutral in 2015–2016.
- *Structural policies.* Although Spain is credited with some significant reforms, the regional reform agenda—including labor-market, spending, and product-market reforms—lags elsewhere in Europe. A comprehensive supply-side reform is needed to raise potential growth, though it should be acknowledged that structural reform often is disruptive politically and economically in the short run.

There are two problems here. First, these remedies are well understood by European leaders—the problem is not imagination, but leadership. Europe remains stuck, and it seems that only a crisis can spur the needed response. Second, the downside of the analogy to Japan and the three arrows of Abenomics is that Europe should also address a fourth arrow—the debt overhang—which exerts a continuing drag on investment and confidence. With the stress test complete, now is the time to address this problem as part of a comprehensive pro-growth package.

DEBT POLICY: THE MISSING FOURTH ARROW

Across Europe, sovereign debt is higher than it was immediately following the financial crisis. Last year, gross government debt was 175 percent of gross domestic product (GDP) in Greece and 133 percent in Italy; Portugal and Ireland's governments both hold debt stocks over 120 percent of GDP. Meanwhile, household and corporate debt remains high and continues to threaten bank balance sheets. Low interest rates make these debt burdens manageable for now, and have allowed countries such as Greece and Portugal to reenter markets. But with growth through 2015 projected at an anemic 1 percent, this is a problem deferred, not solved.

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Continued uncertainty over debt will condemn Europe to years of low growth and its attendant ills. Growth projections for the short- and medium-term are far too low to relieve problems like extreme unemployment—in excess of 35 percent for youths in Spain, Greece, Portugal, and Italy—and the social and political instability it can ignite. Continued weak economic performance will only further reduce confidence and investment, possibly widening the premium on periphery sovereign debt.

The way out of the growth doldrums resides in forcefully tackling the debt problem. Europe's leaders need to find the political will to launch a structured debt-relief program. In my PIM, I argue that one place to begin is by looking to the Paris Club, an informal group of official creditors that convenes to address debt problems in low-

and middle-income countries. Though my European friends hate my analogy to a forum that supports developing countries, clear lessons can be drawn.

Specifically, Europe should implement four of the Paris Club’s principles. First, rules should be adopted on a case-by-case basis to tailor restructuring programs to a country’s income and debt level. Second, predictable debt relief should be conditional on policy performance, including structural reforms, continued progress toward fiscal balance, and programs to address the burden of corporate-sector debt. Third, countries should receive a cutoff date that would delimit the debt eligible for restructuring. In all cases, only debt accrued before that date would be eligible. This makes the country receiving relief fully responsible for any future debt accumulated. Finally, comparability of treatment for other creditors should not be ruled out as needed.

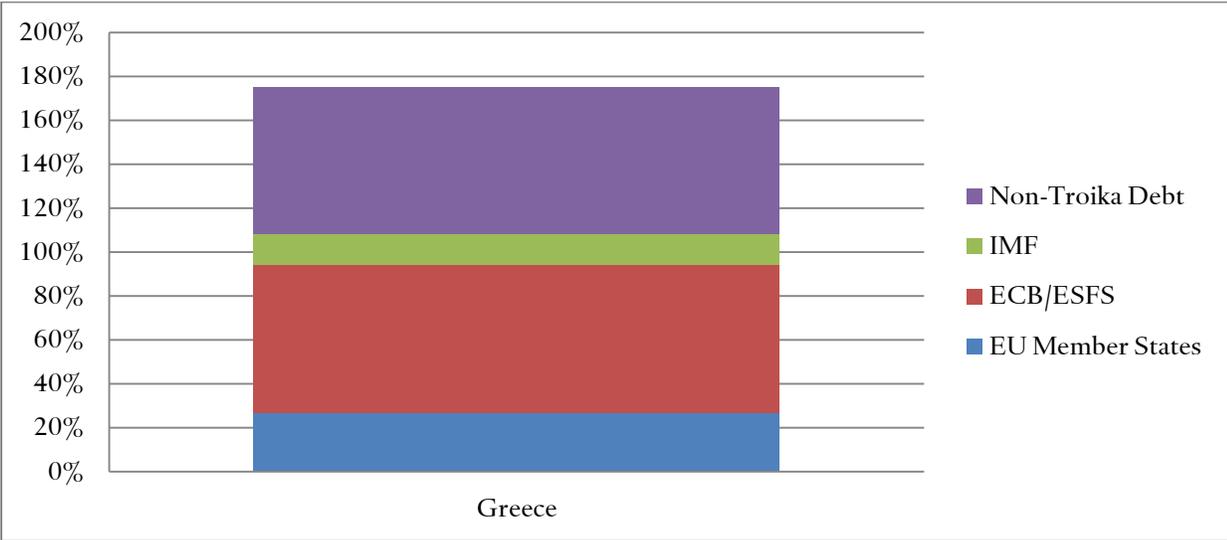
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The Paris Club framework is particularly important in the case of Europe, where much of the debt is owed to creditors in the official sector. This is particularly true in the case of Greece. At the end of last year, Greece had received a total of nearly 215 billion euros from “the Troika”—a group made up of the European Commission, the ECB (through the European Financial Stability Facility, or EFSF), and the IMF. This amount was equivalent to 108 percent of Greece’s 2013 GDP and 62 percent of its total debt stock (see Figure 1). As a result of the 2012 private restructuring, the vast majority of

Greece’s debt is now owed to official creditors. Resolving disputes among these official creditors will be much easier if a set of rules is in place.

In addition, consideration could be given to reducing debt held by the European Central Bank as part of rescue efforts. Citigroup Chief Economist Willem Buiter has an innovative proposal to cancel ECB debt holdings purchased to fund a temporary fiscal stimulus package. The principle also applies to the bonds the ECB has acquired as part of rescue efforts in the periphery.

FIGURE 1: GREECE’S TROIKA AND NON-TROIKA DEBT, YEAR-END 2013



Source: European Commission

Criticisms of proposals like these often start with a call for realism. It is highly unlikely that Germany and the other creditor countries would agree to commit to debt relief, even if highly conditional on policy reform, because such a commitment would make explicit the costs of sustaining the European Monetary Union with an incomplete set of economic policies. These creditors are concerned by the precedent a major debt-relief effort might set and by the issue of moral hazard (i.e., that easy relief would encourage recipient countries to relax their reform efforts and return to their bad old ways). But making explicit the cost of saving the eurozone with all its current members is simply good governance, as compared to hiding the costs by presuming they will be repaid in full. Further, the moral hazard problem, though a real concern, can be addressed by making relief conditional on performance. Finally, over the longer term, Germany does not benefit from killing its export markets in the periphery. These factors together make a compelling case for a structured program of debt relief.

A LOST DECADE

Now is the time to embark on a comprehensive effort to restart growth in Europe, including a fourth arrow aimed at debt reduction. Low interest rates, the relief provided by earlier maturity extensions, and the confidence that could be achieved from the stress test combine to create a window for action on the debt. A year from now, if growth has not returned, indebted governments will be called on to rescue or shore up weak banks, uncertainty will return, and confidence and investment will be much harder to achieve. Europe needs a rules-based approach to debt relief. The Paris Club is one place to look for guidance to begin setting these rules. The sooner they are established, the sooner Europe will see a return to growth. Otherwise, a lost decade looms.

Looking Ahead: Kahn's take on the news on the horizon

Lame outlook for the lame duck

The U.S. Congress faces a long to-do list for the lame-duck session but is likely to achieve little; the international agenda—e.g., IMF reform and trade promotion authority—is likely to be deferred.

More economic woes for Ukraine and Russia

In Ukraine, the IMF team heads out. A large financing gap looms, calling the IMF program into question. Meanwhile, the Russian economy slips into recession.

A global slowdown

October saw analysts marking down their global growth forecasts, a trend likely to continue in November.