A SYMPOSIUM OF VIEWS

Does Europe Need Debt Relief?

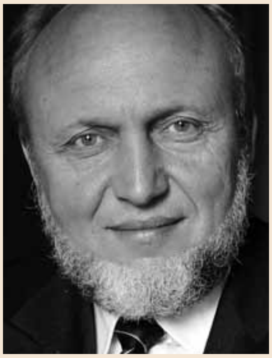
The conventional view is that the eurozone's weak periphery economies are suffering from a lack of demand. Thus, so-called "fresh money" from central banks should lead to higher growth in coming years. Yet other experts, from Thomas Piketty to Hans-Werner Sinn, question whether a different medicine is also needed—namely some form of debt relief (and possibly some means of temporary euro exiting and currency depreciation).

At issue is economic growth. Is the political *status quo* sustainable under the current slow-growth policies, or is a new approach to higher growth rates necessary? By the same token, how can a debt relief program be initiated without igniting a host of unattractive unintended consequences including the diminishing of the credibility of the periphery's credit markets in the long run?

In 1986, then-U.S. Senator Bill Bradley (D-NJ), at a conference in Zürich, called for emerging-market debt relief. At the time, Washington officials labeled this policy initiative highly controversial if not destructive to the financial order. Yet within less than half a decade, many of the same officials were boasting of the success of Brady Bonds.

Is the eurozone in a similar situation—in desperate need of a major conference on debt relief? Are we in the midst of a tectonic shift on debt? Or would such a conference merely encourage more of the fiscal policies and lack of restructuring that led to the economic underperformance and excessive debt in the first place?

More than thirty observers offer their assessment.



It is time now for Greece's public creditors to face the truth: the country is bankrupt.

HANS-WERNER SINN
President, Ifo Institute for Economic Research, and Professor of Economics and Public Finance, University of Munich

In terms of extra credit from the Greek printing press, net purchases of Greek government bonds by other central banks, and fiscal rescue credits provided by other countries, the credit help Greece has received from its partners in the eurozone stood at €325 billion, or 182 percent of GDP, by the end of the first quarter of 2015. This sum was €262 billion larger than five years ago, when a possible Grexit was first vigorously debated in Europe, eventually leading to voluminous fiscal and monetary rescue operations. To put this sum in context, Greece has been supported with the equivalent of thirty-five Marshall Plans of the kind Germany received after the war, which, accumulated over the years, amounted to 5.2 percent of Germany's 1952 GDP. About one-third of the money publicly lent to Greece has been used for financing the Greek current account deficit since 2008, another third was used to replace net foreign debt existing already before 2008, and the remaining third enabled capital flight by Greeks who sold their assets to the banks or borrowed the money to transfer it to other countries.

Despite all the help, the Greek economy is in a shambles. Manufacturing output is 26 percent below the pre-crisis level, while the unemployment rate hovers at 26 percent, more than twice what it was five years ago, when the fiscal rescue measures started. Youth unemployment exceeds 50 percent. Spreads and interest rates are at record levels. On April 16, the interest rate for Greek government bonds with a remaining time to maturity of two years yielded a nominal rate of return of 28 percent.

Surprisingly, capital markets are not spooked by all this mess. The spreads of Italian, Spanish, Portuguese, or Irish government bonds relative to the German bunds are lower than ever. Market participants expect no particular turmoil should Greece default or exit the euro. The explanation is that practically all private financial investment in Greece has by now been replaced with public credit from the printing press or from the fiscal rescue operations.

It is time now for Greece's public creditors to face the truth and accept that the country is bankrupt. Even Greek Finance Minister Yanis Varoufakis insinuated as much in a BBC interview. Whether they like it or not, it is better for the creditors to write off their claims than to throw good money after bad, because that way they would extend the drama and the amount of money being burnt. Relief should be given for government debt, for the Target debt resulting from excessive issuance of money, and for bank debt *vis-à-vis* the local central bank, as they are all interrelated.

At the same time, the ECB should force Greece to impose capital controls, as was done in Cyprus, by stopping the extension of emergency liquidity assistance credit. ELA credit is refinancing credit that the Greek central bank provides to commercial banks purportedly at its own risk. In fact, however, the Greek central bank's risk-bearing capacity is limited by the size of its equity and its ownership share in the Eurosystem's monetary base, which currently amounts to €44 billion. Given that ELA has already reached €74 billion, the admissible limit has been exceeded by €30 billion. This surplus may turn out to be a full gain in wealth for Greek citizens, since most of the money has been used to make their capital flight possible, forcing other central banks to credit Greek citizens' foreign bank accounts in exchange for Target claims that in all likelihood will never be serviced.

But just writing off the debt and stopping capital flight is not enough, as the country must be made competitive in the sense that it must be able to return to high employment without resorting to current account deficits. The best measure to achieve this is a temporary exit from the eurozone, as the subsequent devaluation of the drachma would redirect Greek demand from foreign to domestic products, boost tourism, and, above all, make it attractive for investors to return to Greece to buy real assets at bargain prices and further invest in the country. Nearly all seventy or so state bankruptcies that the world has seen in recent decades that were coupled with devaluations turned into success stories, with the upswing coming within a year or two.

The demonstration effect of such a measure would also be useful, as it would clearly signal that the Eurosystem is no fiscal union, but a currency union without debt mutualization and with rules that have to be obeyed. Keeping Greece in the euro and financing its lack of competitiveness with new public credit, as would undoubtedly be necessary to prevent political turmoil, would have dramatic political contagion effects for other crisis countries, blunting their reform efforts and making Europe sink in a morass of debt.

Debt relief, yes. But the eurozone desperately needs a fiscal transfer mechanism to soften the effects of competitiveness imbalances.

HENRY J. AARON
Bruce and Virginia MacLaury Senior Fellow, Brookings Institution

The eurozone has three problems: national debt obligations that cannot be met, medium-term imbalances in trade competitiveness, and long-term structural flaws.

The short-run problem requires more of the monetary easing that Germany has, with appalling shortsightedness, been resisting, and less of the near-term fiscal restraint that Germany has, with equally appalling shortsightedness, been seeking. To insist that Greece meet all of its near-term current debt service obligations makes about as much sense as did French and British insistence that Germany honor its reparations obligations after World War I. The latter could not be and were not honored. The former cannot and will not be honored either.

The medium-term problem is that, given a single currency, labor costs are too high in Greece and too low in Germany and some other northern European countries. Because adjustments in currency values cannot correct these imbalances, differences in growth of wages must do the job—either wage deflation and continued depression in Greece and other peripheral countries, wage inflation in Germany, or both. The former is a recipe for intense and sustained misery. The latter, however politically improbable it may now seem, is the better alternative.

The long-term problem is that the eurozone lacks the fiscal transfer mechanisms necessary to soften the effects of competitiveness imbalances while other forms of adjustment take effect. This lack places extraordinary demands on the willingness of individual nations to undertake internal policies to reduce such imbalances. Until such fiscal transfer mechanisms are created, crises such as the current one are bound to recur.

Present circumstances call for a combination of short-term expansionary policies that have to be led or accepted by the surplus nations, notably Germany, who will also have to recognize and accept that not all Greek debts will be paid or that debt service payments will not be made on time and at originally negotiated interest rates. The price for those concessions will be a current and credible commitment eventually to restore and maintain fiscal balance by the peripheral countries, notably Greece.

A conference on debt relief would be dangerous.

PHILIPP HILDEBRAND
Vice-Chairman, BlackRock, and former Chairman of the Governing Board, Swiss National Bank

While its GDP per capita remains among the highest in the world, eurozone growth performance in recent years has been poor, with GDP still below its pre-2008 crisis level. This is indeed partly due to a large public and private debt overhang in many countries. However, a conference on debt relief is not needed and would in fact be dangerous. What Europe needs most is reforms that raise its long-term trend growth.

Many eurozone countries have accumulated large sovereign debt-to-GDP ratios as a result of a combination of insufficiently conservative fiscal policy in boom times, banking sector rescues, and recession in the aftermath of the global financial crisis and then the eurozone crisis.

What these countries now need is to grow faster than the interest rate they pay on their debt, and run sensible fiscal policies. The ECB's quantitative easing policy is creating a unique window of opportunity to set those high debt-to-GDP ratios on a declining path, by delivering ultra-low interest rates—but this will last only for a while, less than two years if all goes according to plan. So the key is for governments to deliver structural policies that boost the growth potential of the economy and fiscal policies that do not lead to reaccumulation of debt. While each country is different, most of the high-debt countries have scope to further liberalize their labor markets, reform entitlements, notably public pensions in order to put them on a sounder intertemporal financial footing, and boost competition in the services sector, where productivity gains would cascade throughout the economy. Most countries also have scope to cut public expenditure and rebalance the tax burden in a growth-friendly way.

Debt restructuring generally would not help. This is because, everywhere except in Greece, a high share is owed to residents of the country. Therefore, giving debt relief to debtors would merely transfer the problem to another sector of the economy, notably the banks, which are just getting back to decent health and need to stay healthy if they are to support the recovery. Losses inflicted on banks as a result of debt relief would translate into many times fewer new loans to the economy. Greece is different, as the bulk of its debt is held by foreign creditors. Moreover, it is probably true that its public debt burden is so high relative to the productive base of the economy that it will not be repaid in full, However, at this stage, debt relief would not accomplish anything. What Greece needs above all for now is a fundamental transformation of its productive structure, so the economy can be competitive and grow sustainably both in the near and the long term.

Here's the lesson of the Brady Plan.

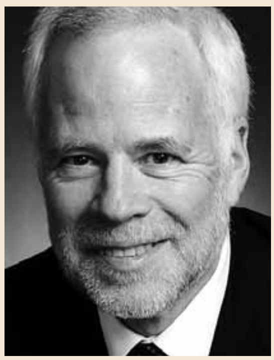
DAVID C. MULFORD
Former U.S. Ambassador to India, and former Under Secretary for International Affairs, U.S. Treasury

There needs to be a reduction of debt in Europe (as opposed to comprehensive relief), but not universally and not without justification by accomplishments in fundamental structural reforms. It is also of vital importance how debt reduction is achieved. Preferably, when accomplished it should be in part by newly structured instruments that are marketed into world financial markets. The objective of debt reduction wherever it is utilized should be successful economic recovery based on reforms already put in place by the peripheral countries.

The Brady Plan would be a good guide for a place to start to do two important things: define the reality actually faced by each debtor country; and select methods that reduce risk exposure by both forcing official lenders to take some of the hit and transferring risk to markets that are willing and sophisticated enough to have appetite for newly structured risk.

Each heavily indebted peripheral country would have to be approached differently, according to its circumstances. One-size-fits-all would be an approach to be avoided. Those governments and government-related entities (probably including the International Monetary Fund) that have provided credit on the basis that they are "preferred creditors" need to accept the logic that they are the creditors who need to design the magnitude of the hit they can take, and the types of instruments they could structure and sponsor for distribution to global markets. The debtor countries would need to buy into the commitment to make structural changes before relief could be forthcoming. The creditworthiness of individual debt reduction candidate countries in the eurozone would need to be based on judgments by markets on the quality of their reforms and the acceptability of the newly structured market instruments.

Should there be a debt conference? Not unless the approach is thought through from beginning to end and agreement is established covering the rules of the process. Bear in mind, the Brady Plan used U.S. Treasury zero coupon thirty-year bonds to reach a broad and diverse world market. Banks took a manageable hit, but they exited excessive exposure risk relatively quickly. The acceptable discount to be applied to the debt (that is, the reduction in debt) was the product of negotiation between individual debtor countries and their creditors. And, importantly, there was no cost to U.S. taxpayers.



Some kind of debt restructuring is all but unavoidable.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

The argument for debt relief for Europe's heavily indebted sovereigns (which means most of them) is clear to anyone able to recall the Latin American debt crisis of the 1980s. A chronic debt overhang creates a persistent drag on growth. And the prospects for heavily indebted European countries to work down their debt-to-GDP ratios to the levels prescribed by the European Union's Fiscal Compact are dim, given the political obstacles to running large, persistent primary budget surpluses (as Ugo Panizza and I have shown in our joint research), along with the demographic headwinds to growing the denominator of the debt-to-GDP ratio.

This makes some kind of debt restructuring—formal or covert, unilateral or concerted—all but unavoidable, and the sooner it is completed, the better. The strategy so far has been to reduce interest rates and lengthy maturities on debt held by the official sector. With quantitative easing, debt held by the official sector will increase still further. That should make further and more meaningful restructuring feasible in principle. The constraint is that 80 percent of losses on such official holdings of sovereign debt will accrue to the national central banks in question, with unfavorable financial implications for their respective sovereigns. If the European Central Bank's shareholders can agree to eliminate this unfortunate 80 percent/20 percent loss-sharing arrangement, then the ECB and its shareholders as a group can recapitalize any national central banks whose balance sheets are seriously impaired by sovereign restructuring. Agreement on the restructuring formula between the ECB's shareholders (governments) and the heavy debtors (governments) would then suffice to proceed. This is the best context in which a debt restructuring could occur.

Europe can move boldly to remove debt overhangs, or dither, undermining growth further.

MOHAMED A. EL-ERIAN
Chief Economic Advisor, Allianz, the parent of PIMCO where he served as CEO (2007–2014), and Chair, President Obama's Global Development Council

Certain parts of Europe urgently need debt relief and the longer it takes to come, the greater the risk to current and future generations.

Like elsewhere in the advanced world, a few segments of European society got hooked in the last decade on a finance-dependent growth model and they took it to extremes. Governments borrowed well beyond their capacity to service this debt over the medium term. Citizens bought houses that they could not really afford, comforted by the notion of ever-higher prices in the future. Banks ventured far and wide in search of all types of financial engineering that would leverage their balance sheets and, thus, what they thought they would earn—often turning a blind eye to risk they did not fully comprehend.

The resulting pockets of over-indebtedness served as both cause and amplifier of a devastating financial crisis. Thereafter, their persistence has done more than just hold back the economic recovery. The "debt overhang" has also discouraged the involvement of new investors, thus limiting the inflow of new oxygen that is so key to economic and financial rehabilitation.

Some countries—such as Ireland and Portugal—have moved impressively to come to grips with their debt issues. In addition to tightening their belts, and supported by their European partners and the International Monetary Fund, they critically put in place the conditions for renewed economic growth. They were helped in the process by a policy of "financial repression," in which central banks, including the European Central Bank, suppress interest rates as a way of subsidizing debtors.

Others, such as Greece, have tried hard to restore financial viability. They too have embarked on ambitious fiscal adjustments. But in failing to also promote economic growth, the result has been an ever-heavier burden of excessive indebtedness. This bigger debt continues to undermine economic activity, turning away new investments, and encouraging citizens to pull their money out of banks (increasing the probability of a "bank jog" turning into a devastating "bank run"). It has also contributed to growing support throughout Europe for non-traditional political parties.

The international community has seen this before, and on more than one occasion.

The curse of the debt overhang was a major contributor to Latin America's "lost decade" of the 1980s and it prompted a major debt and debt service reduction effort spearheaded by the "Brady Plan" (named after U.S. Treasury Secretary Nicholas Brady). A few years later, similar analytical arguments led to the implementation of the "HIPC Initiative" for low-income countries.

Yes, in both these cases there were lots of concerns about moral hazard (that is, the possibility of debt relief substituting for, rather than supporting, good policies). But it was a risk worth taking given the near-certitude that a continued debt overhang would haunt the wellbeing of both current and future generations.

In the event, carefully designed and executed debt relief was part of the solution for restoring growth and financial viability for societies that were struggling mightily. It should also be for the few overwhelmingly indebted segments in Europe. A serious effort to reduce excessive indebtedness needs to accompany an intensification of pro-growth structural reforms and a rebalancing of excessive austerity measures.

Europe has a stark choice in front of it. It can move courageously and boldly now to remove debt overhangs, with all the moral hazard risks that come with that. Alternatively, it can dither and allow the debt overhang to be even more deeply embedded in the structure of the economy, thereby undermining growth further, choking job creation, and increasing the probability of disorderly defaults down the road.

Debt relief won't solve the underlying problem: monetary union.

BERNARD CONNOLLY
CEO, Connolly Insight, LP

Proposals for debt relief in "Europe" are fuzzy. There is no such thing as "Europe." There is, unfortunately, the malignant lunacy of monetary union. But there is, thank goodness, no fiscal union and no debt union.

Presumably the proposals are directed at individual countries. But what debt? The debt of governments to their own citizens is not a matter for outside interference or outside "help." The same is true of private sector debt held domestically. So the question comes down to the external debt, whether public or private, of certain individual countries which do not have their own currency.

Several euro-area countries have very high external debt ratios, the legacy of the enormous current account deficits incurred during the pre-financial crisis period when markets seemed to believe Jean-Claude "monetary union will permit the elimination of risk premiums" Trichet. Countries were in effect running Ponzi games. When the crisis hit, they were faced with the alternatives of default, debt relief, and dramatically reducing domestic absorption in order to achieve trade surpluses consistent with the No-Ponzi-Game condition.

The lending by the European Stability Mechanism and the European Financial Stability Facility with conditions more favorable than those available in the market—a bailout for the lending banks—and the debt-monetization exercises being carried out by the ECB at the expense of, notably, German savers already constitute very significant "debt relief." In Greece there has also already been effective default ("haircuts"). But the major element of the choice was a reduction in domestic absorption.

The underlying problem has been that the process had to rely on expenditure-reducing policies—"austerity"—to too great an extent because expenditure-switching policies—currency depreciation—were not available. In countries such as Greece, Spain, and Portugal, which are not particularly open despite being small, relying on expenditure reduction implied an enormous fall in domestic demand. The result has been mass unemployment and actual or incipient deflation, both of which make debt burdens less sustainable. It appears that the full-employment trade balances of these countries have improved very little. If unemployment remains massively high, productive potential will be damaged further, deflation will become persistent, and debt burdens will become intolerable financially, socially, and politically. Default becomes inevitable. If instead external lenders again begin to ignore the implications of the No-Ponzi-Game constraint, as in Spain at present, current account deficits will blow out again, also making default ultimately inevitable.

The problem with "debt relief" is that it makes little difference to the underlying problem. It marginally reduces the required full-employment trade surplus. But the countries concerned still have very large full-employment trade deficits. To avoid ultimate default would require (assuming that massive euro depreciation and rip-roaring inflation in Germany is ruled out) not just relief of existing debt, but also a perpetual stream of unrequited transfers equal to the full-employment trade deficit. Because such a "Europe" does not and should not exist, the only logical conclusion is that the monetary union is unsustainable.

Maybe debt reduction can be a reward for accomplishing economic reform.

JEFFREY R. SHAFER
Former Undersecretary for International Affairs, U.S. Treasury

More than five years ago, when the economic imbalances within the euro area became apparent, a sound program to deal with them would have entailed three elements: first, debt restructuring to reduce outsized debt burdens; second, departure from the euro by at least Greece and perhaps others to correct huge competitiveness imbalances; and last, reforms to address the grossly distorted incentives resulting from government policies. Such an approach would have required international financial support to allow time for policies to produce results. Programs would have needed to be case-by-case since each country had fallen into difficulty in different ways—Greece through fiscal irresponsibility, Ireland and Spain through housing bubbles financed by banks with foreign money, Italy through legacy debt and incentives that destroyed growth, and Portugal through some of all of these.

Instead, we have seen austerity that has resulted in higher, not lower, debt burdens, internal devaluations that have gone a considerable way to correct competitiveness imbalances but at a terrible price in lost output and unemployment, and very little effective reform. Greece has had a restructuring of its debt to the private sector, but this fell far short of what is needed to bring its government debt down to a size that is not crushing. The prospects for the euro area periphery achieving strong growth and reducing unemployment still remain poor.

What is needed now to give the people of the euro area periphery hope in their economic future? Departure from the euro can be taken off the table given the painful progress that has been made over half a decade of internal devaluation, but debt relief through restructuring is more needed now than it was in 2010. Each country is in a different situation so the approach must be case by case. Greece is most straightforward given the extraordinary level of its debt and its concentration in the hands of official institutions. A Paris Club-type approach seems appropriate for Greece. In other countries, the debt is more privately held and often in the hands of domestic banks and other residents. And some countries may be able to move to more comfortable debt levels without restructuring or further onerous austerity. But each case needs to be looked at carefully and without the unwarranted optimism that has characterized debt sustainability discussions until now.

Debt restructuring will do little or nothing to improve economic prospects without deep tax and regulatory reforms to enable people and provide them with incentives to work, to hire workers, to open businesses, and to invest in physical, intangible, and human capital. Leadership in some countries is seeking to do this, particularly—and forcefully—Prime Minister Matteo Renzi in Italy. He and others would have a better chance of political success if their fellow Europeans were willing to reward them with debt reduction for implementing reforms and backstop their financial capacity to bridge until they produce results.

Proposals for quick fixes to reduce debt levels are no real solutions.

LUDGER SCHUKNECHT

Chief Economist and Head, Directorate for General Fiscal Policy and International Financial and Monetary Policy, Ministry of Finance, Germany, and former Senior Advisor, General Economics Directorate, European Central Bank

Over the last three decades, we have seen an enormous built-up in private and public debt in almost all advanced countries—not just in Europe. At the same time, economic growth rates have been declining and there have been a number of financial crises. This sends a clear first message: the debt-financed growth model of the past decades is not sustainable and has reached its limits.

What do we then need to do to address very high public debt in many advanced countries? My answer is rather straightforward: there is no way around growth-friendly fiscal consolidation and well-designed structural reforms. We need to improve the sustainability of public budgets by setting clear priorities, privileging investment, and preparing for demographic challenges. Privatizations can support debt reduction and, at the same time, help modernize the economy and incentivize private sector investment. Experiences in many countries show that fiscal consolidation and structural reforms complement each other, thus providing a double dividend of more sustainable public finances and higher growth. Declining fiscal deficits in Europe and regained confidence in Ireland, Portugal, and Spain are a clear sign that this approach works.

In case public debt still proves too high and markets lose confidence, there are well-established safety nets plus conditionality. The euro area has provided significant financial assistance to members in exchange for reform programs that aim to correct domestic imbalances and re-establish confidence. Should debt prove unsustainable, collective action clauses, which all euro area members are obliged to incorporate in new bond issuances, could contribute to orderly debt restructurings. The International Monetary Fund has been advocating such contractual approaches for decades. Their recent idea of automatic prolongations during financial assistance programs should be pursued further.

Unfortunately, proposals for quick fixes to reduce debt levels are—as is the nature of most quick fixes—no real solutions. We have learned from the history of socialism and from the financial crisis that a mere risk-shifting or mutualization does not make debt nor the related structural weaknesses disappear. It would lead to moral hazard on the part of the beneficiary. It would lack credibility as it would quickly reach its limits if a big country were affected. And it would be politically extremely divisive. Offloading debt onto others—be it through euro bonds, a common debt redemption fund, or monetization—would therefore do more harm than good.

The European framework of fiscal rules, temporary support mechanisms, and market discipline including the restructuring option provides an effective overall approach with well-aligned incentives. It is now all about appropriate implementation.

There is absolutely no need for panic solutions.

JACOB FUNK KIRKEGAARD

Senior Fellow, Peterson Institute for International Economics

No! The euro area does not need a continent-wide debt conference, debt principal-reducing bond swaps, exits from the common currency area, or any other extraordinary political or financial measures to reduce what remains a substantial debt overhang. There are at least three reasons for this conclusion.

First of all, the euro area today is far more politically resilient than generally believed (not least in the Anglo-Saxon world) and is not on the cusp of a 1930s-style descent into political populism and extremism. There is consequently no political imperative to "change course before it is too late," as the euro area political systems can sustain the challenges faced. Sure, welfare chauvinist populist parties have emerged in many member states, but that is hardly surprising on the back of years of record immigration and the centrist shift of many social-democratic parties. As amply illustrated by the Syriza-led government in Greece, there remains however no credible radical policy alternative to the current euro area consensus. This is something the likely centrist-shift/collapse of the Greek government will serve to illustrate. With still-affluent and aging popular majorities holding political power, no euro area member will in the end make this choice.

Second, euro area debt levels—public or private—are quite sustainable when analyzed at the aggregate level. This matters once it is realized that the euro area institutions created since 2010 amount to a political conditional bail-out union, where fiscal crisis assistance and ultimately transfers are available in exchange for the surrender of national control over economic policies. Whether an ESM program, where aid can ultimately be converted into *de facto* transfers via concessionary decade-long interest rates, or an ECB OMT program granting a politically conditional lender-of-last-resort function, the euro area has the means to rescue crisis-stricken members in a politically sustainable manner. As is currently witnessed in Greece, once the public realizes just how large the costs of abandoning current policies are, *quid pro quo* reform requirements are politically manageable once governments possess administrative capabilities generally expected of advanced economies.

Third, it is clear that euro area economies need to become better at quickly realizing private financial losses before these grow into what invariably in the past have become public liabilities. This requires reforming many national bankruptcy codes to facilitate negotiated private restructurings; expedited judicial processing; the presence of deep-pocketed distressed asset managers; and not least, a banking sector with sufficient capital to withstand large losses and a supervisor free of national political constraints to impose such losses through timely write-downs.

The euro area has in recent years made quite a bit of progress on these latter requirements, though the single banking supervisor and national governments still have some ground to cover. There is absolutely no need for panic solutions, but rather the euro area needs now to carry on.

If sovereign debt is officially seen as subject to default risk, an insolvency procedure is essential.

THOMAS MAYER

Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank.

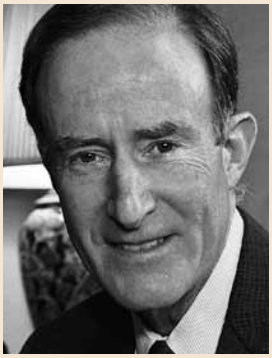
In our "fiat" money system, the state has delegated to its central bank the task of managing the public-private partnership of money production. Commercial banks create book money through credit extension while the central bank supplies reserve money to the banks and banknotes to the public. In this system, the demand for credit drives the creation of money. The state cannot go bankrupt as long as it borrows in its own currency, because the central bank can always buy its bonds against its own money as a last resort, either through the commercial banks or directly, if the state chooses to adjust the statutes of the central bank accordingly. State bankruptcy is only possible if the state has borrowed in foreign currency that its central bank cannot produce. Since borrowing in foreign currency has been largely confined to less-developed and emerging market economies with limited votes in international organizations, efforts at creating an international insolvency procedure for sovereign borrowers have so far failed.

Member countries of the European monetary union are in an entirely different situation. Issuance of their money is managed by a supra-national central bank that they do not control. For them, all government debt is like foreign currency debt. EMU is in trouble because neither EMU member states nor the banks operating in these states understood this, and they behaved as if the states were issuing domestic currency debt. States over-borrowed and banks over-lended with the result that over-indebted states threatened to bankrupt banks, and vice versa.

To avoid the collapse of EMU, the European Central Bank assumed the role of buyer of last resort of government bonds. But this is in conflict with its statutes and creates moral hazard among governments. They can benefit individually from ECB purchases of their bonds while the costs in the form of higher inflation due to excessive money creation are borne collectively by all member states. A monetary union of sovereign states will eventually break up when each state can abuse the common central bank as buyer of last resort of its debt.

To survive in the long term, EMU needs an insolvency procedure for sovereign debtors. Like in the Brady Plan of the 1990s, debt restructuring could be facilitated if a European institution, perhaps the European Stability Mechanism, guaranteed the restructured debt. Creditors would suffer losses in the form of a haircut on their claims, but they would receive a safer asset in exchange. In order to avoid a permanent mutualization of debt through this mechanism, governments would have to exit EMU if they failed to pay down the guaranteed debt over time.

A consensus seems to have emerged among policymakers that the debt of EMU sovereign entities is not risk-free. Banks must be subject to credit limits and need to set aside equity when they lend to EMU governments. But if sovereign debt in the euro area is officially seen as subject to default risk, an insolvency procedure for EMU governments is essential.



There is no economic or moral ground for Germany to be the only European country in modern times to be granted debt relief.

BENJAMIN M. FRIEDMAN
William Joseph Maier Professor of Political Economy, Harvard University, and author,* The Moral Consequences of Economic Growth *(2006)

Europe today is falling apart economically. The missing part of the remedy is debt restructuring and debt relief (and in real time the two are often impossible to distinguish) for the most highly burdened countries. Part of the problem is that those countries' debt—most obviously Greece's—is increasingly held by official lenders, and, supposedly, official lenders do not take losses. But that well-accepted principle is a fiction, and in this case not a helpful one.

There is ample precedent for large-scale debt relief from within Europe's modern history: Germany. In 1924. In 1929. In 1932. Above all, in 1953. Moreover, the motivating principle behind the 1953 London Debt Agreement, in the words of one historian of the period, was "that Germany's actual payments could not be so high as to endanger the short-term welfare of her people … reducing German consumption was not an acceptable way to ensure repayment of the debts." Without debt relief and restructuring on the scale that Germany received, the country's post-war "economic miracle" would have been, at the least, long delayed. It may have been impossible.

The contrast between the principles underlying the 1953 agreement and both the spirit and the implementation of Europe's approach to today's overly indebted countries is stark. The austerity measures imposed by their creditors have resulted in protracted economic stagnation, declining living standards, and widespread unemployment. And as has happened so often in the past, the all-too-familiar consequence of these economic hardships is a turn away from small-L liberal values toward the xenophobic populism of either the right or the left. Today Europe's political center is falling apart, too.

There is no economic ground for Germany to be the only European country in modern times to be granted official debt relief on a massive scale, and certainly no moral ground either. For Germany—of all countries—to block debt relief for those European countries that need it today is wrong, both economically and morally.

STEPHEN G. CECCHETTI
Professor, Brandeis University, and former Head of the Monetary and Economic Department, Bank for International Settlements

KIM SCHOENHOLTZ
Professor of Management Practice and Director of the Center for Global Economy and Business, Stern School of Business, New York University

The writedowns needed would be huge.

Much of Europe lives under the burden of heavy debt that is imposing a drag on growth. Nonfinancial corporate debt exceeds 100 percent of GDP in Belgium, Finland, France, Ireland, Luxembourg, Netherlands, Portugal, and Spain. And net government debt is close to or exceeds this threshold in much of the euro area, bar Austria and Germany.

With interest rates already so low, monetary stimulus is providing a boost to demand primarily through a weak currency. Domestically, increases in nonperforming loans in portions of the periphery suggest that debtors are already beyond the point where cheaper money can (or should) lead them to borrow more.

We see three ways out of this predicament: first, breathtaking supply reforms that trigger an investment boom; second, inflation; or third, a mix of asset sales and debt relief. No advanced economy is rushing to try the first (and best) option, so let's analyze the other two.

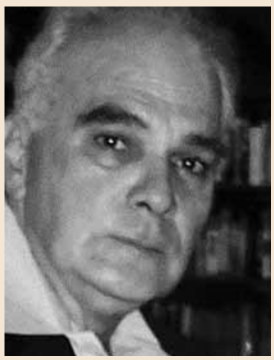
While a big inflation would help borrowers, it would undermine the monetary union built on a foundation of price stability. If the goal is to save the euro, some mix of asset sales and debt relief is the only viable alternative. But write-downs will hurt banks and do long-run damage to credibility.

Without asset sales, how big would the write-downs have to be to restore long-run sustainability? To get some idea, consider the example of Italy. Italian GDP is currently about €1.6 trillion. According to Eurostat, Italian general government debt is 132 percent of GDP. Using ECB statistics, we estimate that one-third of Italian government liabilities are held by Italian banks, while capital plus reserves in the Italian banking system is 27 percent of GDP.

We can now ask the following question: How big a writedown would Italy need for the government to be left with debt equal to 60 percent of GDP (the Maastricht criterion) after recapitalizing the banks? The answer is more than 80 percent! That is, first the current debt of €2.1 trillion would have to be written down to €360 billion. This would leave a hole of nearly €610 billion on banks' balance sheets. Borrowing to fill that leaves the Italian government debt at €970 billion, or 60 percent of GDP.

As extreme as this sounds, we aren't done. European governments have significant unfunded pension liabilities. The case of Italy is again instructive. Because of the aging of its population, estimates of the present value of its pension liabilities typically exceed 100 percent of GDP. This, too, needs fixing.

So yes, without asset sales and supply reforms, we need big write-downs. But we'd be much better off with the former. Absent radical reforms, some European governments are very unlikely to meet the promises they have made either to their borrowers or to their citizenry more broadly. The sooner they own up to this, the better.



Something analogous to the Washington Consensus is needed in Europe.

CRITON M. ZOAKOS
President (1994-2014), Leto Research LLC

Debt relief *per se* will do nothing to solve Europe's problems, and could exacerbate them. Under current political circumstances, debt relief would penalize pensioners and other fixed-income groups, reward the incumbent governments' fiscal profligacy, and do nothing to stimulate growth while failing to make the total debt burden sustainable.

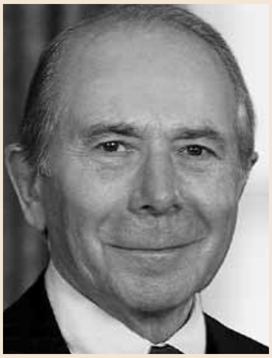
What Europe needs is an entrepreneurial structural reform that will favor the emergence of new markets for innovative products and services at the expense of the current, zero-marginal-profit markets of goods and services. This would mean a reversal of priorities for Europe's reformers, with primary emphasis on a breakup of the protected markets for goods and services and only secondary emphasis on reforming the labor markets.

A structural reform of this type (not contemplated anywhere in the European Union) could employ debt restructuring as a tool subordinated to the aim of achieving these structural reform objectives. Only in this sense does Europe need debt reform: as a tool for organizing an orderly transfer of investable resources away from the traditional and highly protected mix of goods and services and toward the new, innovative markets that the reforms would aim to establish. For example, the tax breaks and other entrepreneurial incentives required for the structural reforms could be funded from a reduction of the debt service payments of restructured public debt. Reforms of corporate and household debt (including bankruptcies) could be useful only if they could be designed to trigger competition, innovation, and entrepreneurial initiative.

The Brady Plan was introduced in 1989—the year of the fall of the Berlin Wall and the worldwide launching of revolutionary structural reforms known as the Washington Consensus. The post-1989 success of the Brady Plan (the relaunching of growth among Third World debtors) was due to these the revolutionary structural reforms of the Washington Consensus rather than to the cleverness of the financial engineers of the Brady bonds.

Something analogous to the Washington Consensus reforms is needed in Europe if a debt relief plan is to succeed in relaunching growth. But Europe is not ready for this; quite the contrary. At the April 2009 London G-20 Summit, European leaders took the opportunity of the ongoing, raging financial crisis to declare that "the Washington Consensus is dead." Ever since then, every lame conceptual attempt to imagine freeing Europe's goods and services markets from the dead hand of regulatory protectionism was stifled at birth.

In Europe at the moment, both the owners of capital and the owners of labor oppose vigorously these types of structural reforms. But without such reform, the politics of introducing Brady-style debt relief conferences will be reduced to struggles between those two groups over who will to pay for debt relief: the owners of capital or the owners of labor. The only outcome of debt relief without revolutionary, entrepreneurial structural reforms in the markets for goods and services (rather than in the labor market) will be the typical European class struggle. History has shown how dangerous this can be.



A forced writedown could threaten the solvency of the EU banking institutions.

HANK GREENBERG
Chairman & CEO, C.V. Starr & Co., Inc.

The debt problem in Europe is complicated, since different countries face different problems requiring different solutions. Ireland, for example, had a major homeowner mortgage debt problem that overwhelmed the financial stability of its banking system. The problem was successfully addressed with the aid of the European Central Bank that forced the writedown of the mortgage debt and forced the government to acquire the insolvent banking system and recapitalize it. Greece, on the other hand, is not burdened with excessive individual debt but rather with excessive government debt, bloated inefficient state-owned companies that drain government resources, and massive tax evasion. Debt writedowns in Greece would only reward bad government policies without attacking excessive government presence in the private sector and the tax evasion problem. The problems in Spain, Italy, and Portugal are similar to those of Greece, though on a lesser scale. Restrictive labor laws in these countries have hindered job creation and forced people to work off the books.

Quantitative easing, in the form of the proposed purchase by the European Central Bank of government bonds of the heavily indebted countries, has been proposed to stimulate aggregate demand and through increased inflation reduce the burden of debt on the indebted economies. Although quantitative easing has helped to lower interest rates that, with the exception of Greece, are already low by international standards, I question whether low rates alone will have the desired stimulative effect. The secondary effect of lower interest rates contributing to a decline in the value of the euro relative to its major trading partners should stimulate both exports and overall growth in the European Union. Direct debt relief in the form of writedowns of the value of the indebtedness of the peripheral EU countries (Portugal, Italy, Greece, and Spain) may not be practical. A substantial portion of the debt of these countries is held by the major banking institutions of the European Union, and a forced writedown could threaten their solvency. Limited debt relief in the form of reduced interest rates on existing debt brought about in part by quantitative easing will not alone solve the financial problems of the heavily indebted countries. The political system in many European countries does not, at this time, encourage the structural reforms necessary to deliver an environment conducive to sustainable growth that will provide a permanent solution to these problems in the future. Enlightened government policies that encourage capital formation and balance government expenditures with revenues could create a situation where, in time, these countries could grow out of their problems. However, harsh terms such as imposed on Greece in the form of immediate government layoffs serve only to shock the economy, reduce its gross national product, and exacerbate the burden of debt on its economy.

The arguments for debt reduction are compelling.

WILLIAM R. WHITE
Former Economic Adviser, Bank for International Settlements

The arguments for explicit sovereign debt reduction in Greece and potentially other small peripheral countries are compelling. First, current debt levels are very high and "debt sustainability" conditions demand that these countries run very high primary surpluses for years to come. Moreover, by curtailing demand, fiscal austerity actually seems to have worsened the problem of debt sustainability. The McKinsey Global Institute recently noted that, in spite of massive fiscal cuts, Greece, Ireland, Portugal, and Spain were among the six countries (of forty-seven) that recorded the largest increase in their debt-to-GDP ratio between 2007 and 2014. Structural reforms are also threatened by very high debt levels. Why undertake painful structural reforms if only the creditors benefit through enhanced debt service prospects? Finally, the political dimension must be explicitly recognized. If all a country can look forward to is decades of penury, it is inevitable that radical political parties promising a better future will flourish. This would constitute an existential threat to the eurozone itself.

Unfortunately, the arguments against writing down the face value of sovereign debts cannot be easily ignored. First, there is the legitimate concern that debt relief will weaken rather than strengthen the resolve to carry out needed structural reforms. At the least, debt relief should be conditional on the implementation of agreed policy measures. Second, there is the concern that relief granted to one small country might spread to demands for similar treatment from other larger countries. This could easily exhaust the fiscal capacities of even core countries. Moreover, in the case of peripheral countries whose sovereign debt is still largely in private hands, this could result in a destructive rise in interest rates. Third, it is argued that debt relief can be provided in a variety of more subtle ways, and indeed already has been. Finally, there is an important political dimension. Ordinary citizens in the core countries seem unalterably opposed to using yet more taxpayer money to support peripheral countries. Should politicians nevertheless decide to do so, this will only deepen the "democratic deficit" from which the eurozone already suffers.

If some further form of debt relief is decided upon, the implications for the solvency of all the banking systems in the eurozone must be dealt with definitively, preferably before the debt restructuring is announced. In this process there must be no repeat of earlier mistakes. Bankers and those who lent to them were allowed to exit without taking their fair share of the losses arising from their imprudent lending. This exit for the rich and powerful implied that the losses would henceforth have to be shared between "Greek taxi drivers" and "German taxpayers," both of whom now feel unfairly burdened. This legacy of distrust between the broad public in both the core and the peripheral countries could seriously impede the formation of the various "unions" that the eurozone still needs for its longer-term survival.

The key is growth.

EWALD NOWOTNY
Governor, Austrian National Bank

The most promising path toward debt sustainability is growth.

It is widely recognized that public debt is a serious problem in many advanced economies in and outside the euro area. The fact that the so-called "sovereign" debt crisis (which incidentally was not only caused by public but also private debt accumulation) occurred in Europe—despite comparable debt levels elsewhere—has certainly to do with the incomplete institutional setting of Europe's economic and monetary union. During the crisis, however, it was made clear that vulnerable countries can count on European solidarity. Assistance was granted to help governments overcome temporary liquidity constraints and reduce financing costs in exchange for a strong commitment to fiscal consolidation and structural reforms.

Debt relief, in the literal sense of the term, has never been considered as the strategy of choice in the euro area for at least three reasons. First, such a short-term solution potentially carries a penalty for the particular sovereign, as any "credit event" may trigger a long-term increase in bond yields. Second, there is the possibility of negative spillover effects, as markets could question the debt sustainability of other euro area countries that share the debt burden. Third, having been granted debt relief, a government may lose some of its incentive to carry out the reforms needed to avoid over-indebtedness in the future.

Instead of eyeing debt like a deer caught in the headlights, we should rather concentrate on GDP growth. Nominal GDP affects the debt-to-GDP ratio in two ways. On the one hand, GDP growth increases tax revenues and reduces social expenditures, thus lowering debt directly. On the other hand, GDP is obviously the denominator in the debt ratio. Taken together, this implies an overproportionally inverse relationship of GDP to debt. Lack of (expected) GDP growth raised financial markets' doubts about the sustainability of some sovereign debtors, thus contributing to the crisis. It is only logical to focus on growth in order to improve debt-carrying capacity. As an added bonus, investors would reward increased confidence by lowering government bond yields.

Fortunately, the European Union has already embraced important elements of a comprehensive growth strategy. The European Commission's Investment Plan aims to fill the investment gap inherited from the crisis. Also, after years of painful consolidation, the European fiscal stance is broadly GDP-neutral. Furthermore, the ECB's accommodative monetary policy, including quantitative easing, is targeted at bringing inflation back in line with the Eurosystem's definition of price stability in the medium run (inflation below, but close to, 2 percent). This is relevant not least because negative inflation raises the real value of government debt. Luckily, falling energy prices and more favorable exchange rates help to improve growth prospects for the euro area. However, there is no room for complacency, as both long-term growth and debt sustainability also hinge on continued institutional reforms which need to be carried out in order to achieve a genuine economic and monetary union.

A widespread debt relief program is not necessary and not desirable.

LORENZO CODOGNO

Visiting Professor, European Institute, London School of Economics, and Founder and Chief Economist, LC Macro Advisors

Winston Churchill once famously said: "No compromise on the main purpose; no peace till victory; no pact with unrepentant wrong." The problem with today's Greek saga is that both Greece and the rest of the eurozone appear to have Churchill's attitude in the negotiations. And with such attitude, they go nowhere.

Needless to say, Greece needs to commit to deep structural reforms and in exchange should get some leeway to support domestic demand, including liquidity and demand support from the European Central Bank. Some further restructuring of the Greek debt seems inevitable at this stage, but it needs to be carefully negotiated and agreed with creditors. It may take the form of some further lowering of the interest rate burden, further lengthening of maturities, and maybe even some debt repayment linked to GDP growth.

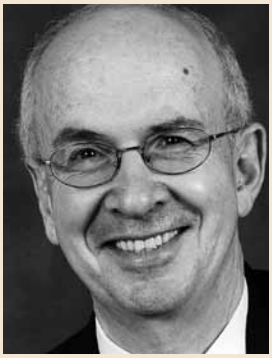
With such an arrangement, even a debt-to-GDP ratio north of 175 percent would look sustainable, provided there is a sufficiently long period of low interest rates and economic growth starts picking up. The risk is that Greece decides for unilateral default (the incentive is high given that more than 80 percent of debt is in the hands of foreign institutions), which would set in motion a series of events that may lead to Grexit. Some form of agreed debt relief for Greece is inevitable, but Grexit must be avoided.

No other country needs debt relief. Italy is running a sizeable current account surplus and the budget is close to balance: what it really needs is a pick-up in economic growth, which would help turn the negative debt dynamics. Other "peripheral" countries with high debt-to-GDP levels have done their homework. The ongoing eurozone economic recovery will alleviate the burden of adjustment and lift all boats.

A widespread debt relief program is not necessary and not desirable. The "legacy debt" and "debt overhang" problems may become a real problem only if the size of debt deters voluntary new lending to a country.

The eurozone needs pro-growth economic policies, more fiscal and financial integration, and possibly a clear move towards fiscal union, which would also imply a steady path towards mutualization of debt at some point in the future. A clear roadmap toward full-fledged economic and political union would serve as an anchor for expectations and make sure that the servicing of debt remains sustainable. In the meantime, peer pressure, market pressure, and the OMT are here to help countries continue along the path of structural reforms without incurring the mistakes of the past.

To quote again Churchill: "Success consists of going from failure to failure without loss of enthusiasm."



Fortunately for Europe, debt restructuring is a lot easier than under English or American law.

DESMOND LACHMAN

Resident Fellow, American Enterprise Institute

There is both bad news and good news about Europe's current debt situation. The bad news is that most countries in the European economic periphery have private and public sector debt levels that are unsustainable. The good news is that, aside from Greece's debt, most of this debt was issued under domestic law. This makes that debt very much easier to restructure than if that debt were issued under either English or American law.

Despite many years of budget austerity, the sad truth is that today's public debt levels in the European economic periphery are very much higher than they were at the start of the eurozone debt crisis. Indeed, Greece's public debt-to-GDP ratio is now at around 175 percent, Italy's is at 133 percent, while that of Ireland and Portugal are at around 125 percent. On top of those very high and rising public debt levels, a number of countries in the periphery, most notably Portugal and Spain, have uncomfortably very high private sector debt levels.

In the context of the very sluggish economic growth and outright price deflation that now characterizes the periphery, those economies would need to generate large primary budget surpluses simply to stabilize their public debt ratios. That in turn would require several more years of painful budget austerity. However, if we should have learned anything from the European debt crisis, it is how counterproductive it can be to pursue budget austerity within a euro straitjacket that precludes currency devaluation as an offset to budget tightening.

Fortunately for the European periphery, most of the debt that it has issued is subject to domestic rather than to English or American law. As such, in principle that debt can be restructured by domestic legislative action aimed at redefining the terms of debt contracts. One has to hope that the countries in the European periphery avail themselves of the leverage that such a route to debt restructuring affords them to extract from their European partners concessions for an orderly debt restructuring. The alternative would be for those countries to hew to the budget austerity policies of the past that have already done so much damage to European economic performance and to the European political fabric.

More rolling over and more "reprofiling" are probably in the cards.

JEFFREY A. FRANKEL

James W. Harpel Professor, Kennedy School of Government, Harvard University, and Director, Program in International Finance and Macroeconomics, National Bureau of Economic Research

It is true that a pattern of the past is to say in the first years of a crisis, "It's a liquidity problem, not a solvency problem," and nevertheless later on to acknowledge that countries can't pay, because the debt overhang is holding back growth, and so to write it down. The eurozone should have written down more of the debt earlier (after sending Greece to the International Monetary Fund earlier than they did). But at this point in the Greek crisis, unlike the time of the Brady Plan in the late 1980s, most of the sovereign debt is held by public institutions such as the European Central Bank and IMF. These institutions don't write down debt. Nevertheless, more rolling over and more "reprofiling" are probably in the cards. What Europe really needs is more structural conditionality and less fiscal austerity.

Debt relief is probably necessary, but only for those countries dependent on overseas capital.

JIM O'NEILL
Former Chairman, Asset Management, Goldman Sachs International

Probably Europe, or some parts of Europe, needs debt relief. Other places too, such as Japan, have as much justification, and more importantly, what many highly indebted countries share is a need for growth, especially those with poor demographics.

The Greek crisis highlights the core dilemma of countries that increase their underlying debt levels seemingly for ever, and suddenly lose their political will and/or popular support for policies to persist with restrictive fiscal policies, the conventional remedy to solve such problems. Amongst many complicating issues about the Greek debt crisis, a simple truth appears to emerge through the complexity. Greek debt levels appear to have risen despite a huge shift in fiscal policy since 2010 and the onset of the euro crisis since resulting nominal GDP growth has been hopelessly insufficient to reduce the growth of indebtedness. What is also true is that the growth that had occurred in the decade before the crisis itself resulted in sharply rising levels of debt. This tends to suggest that what countries such as Greece need is a "better" way of trying to achieve sustainable and real GDP growth. This is probably pretty applicable for other European countries and some beyond Europe.

The first country I was ever allowed to study when I entered the professional world of economic analysis in finance was Italy, at the start of the 1980s, and I worked for a large U.S. bank, then headquartered in San Francisco, and it was persistently assumed that Italy had unsustainable debt levels and it would be a matter of time until they defaulted and needed to reschedule their debts. Here we are thirty-five years later, and Italy has not—at least yet—defaulted. But Italy is stuck in an environment of no real growth and its debt levels, after some modest improvement in the 1990s and 2000s, have recently risen sharply again. Would Italy have benefited from debt relief in the 1980s? Or is Italy the example that questions the generalized implicit assumption in the question asked here?

And what about Japan? Ever since the collapse of the Japanese miracle at the start of the 1990s, Japan's nominal debt has risen sharply and there have been numerous predictions of a major economic crisis in Japan and imminent collapse of their bond market. As of yet, Japan has not had a crisis, although its economy has been essentially stagnant for over twenty years. When I dreamed up the BRIC acronym in 2001, Japan's economy was much larger than that of China, while today it is half the size of China's.

So I find myself thinking that debt relief is probably necessary, but only crucial for those countries that are especially dependent on overseas capital. In the case of Italy and Japan, they have plenty of domestic savers, and are important enough for the world for global policymakers to be very wary of an uncontrolled debt event. There is a big difference between the likes of Italy and Japan, and examples from the emerging world of the past that have successfully coped with major debt write-offs.

What is more obviously needed is the holy grail of higher productivity and sustainable growth, especially for countries such as Italy and Japan that have such huge demographic challenges and are likely to have rather poor underlying growth trends as well. How they can be achieved seems in principle relatively straightforward, but to actually execute in practice without a true crisis to shake up the *status quo* remains as difficult as ever.

Excessive debt stocks are the least of the problems the southern European countries face.

JOHN WILLIAMSON
Senior Fellow (retired), Peterson Institute for International Economics

The key question is whether the economies of southern Europe are capable of faster economic growth without debt relief, temporary exit from the euro, or additional depreciation. I am confident that economic growth would return some day: the real danger is of it not returning before an implosion of the political system occurs.

The reason the economies of southern Europe got into trouble is that they inflated too fast relative to the economies of northern Europe, notably Germany. (The traditional remedy, currency depreciation, is excluded by membership in the euro, temporary exit from which is impossible without also destroying the rationale for entering, which was to destroy an inbuilt inflationary process.) It follows that the necessary condition is a reduction in relative unit labor costs in the southern European countries. With the exception of Italy, the southern European countries have in fact made good progress toward this goal. Indeed, last year we began to hope that Greece had already made it.

The principal problem they have encountered is that the necessary reduction in relative unit labor costs has been almost entirely left to them. In a well-functioning monetary union, their reduction in unit labor costs would be matched by rising unit labor costs in the surplus economies (and no change or a minimal increase in unit labor costs in a typical economy). The result would be that the necessary change in relative unit labor costs would be accomplished with only a fraction of the pain involved in unilateral adjustment.

How have Germany and the Netherlands (the two principal surplus economies) matched this challenge? The latest Price and Cost data from the European Commission are not encouraging. While the deficit countries of southern Europe (Italy excepted) have improved their competitiveness, generally by between 5 percent and 15 percent on various indicators, the surplus countries of northern Europe show negligible, and on some indicators negative, changes. For example, by great sacrifices Greece reduced its unit labor cost in manufacturing by 7.2 percent relative to the euro area average, but this was partially offset because Germany also reduced its unit labor cost in manufacturing by almost 2 percent.

The conclusion one is driven to is that Germany (and also the Netherlands) have not yet learned to be good creditors. A good creditor shares in the costs of adjustment, so that the burden on the debtors is attenuated, not exaggerated. Had this occurred, adjustment would now be complete (Italy excepted). It would have occurred before political implosion. The method would have involved higher wages in the surplus economies—hardly an unbearable burden.

Should Germany also share in the costs via debt relief? Debt relief for the Latin American countries was a psychological necessity, to show that the creditors were sharing in the pain. It would be much more constructive if Germany resolved that in future it would share the costs of adjustment, and a handsome apology for its past failings would probably suffice. Failing that, it is altogether likely that Germany will be obliged to grant debt relief. But do not expect any miracles from this initiative. Excessive debt stocks are the least of the problems the southern European countries face.

Debt relief might be worth it in exchange for economic reforms.

MILTON EZRATI

Senior Economist and Market Strategist, Lord, Abbett & Co., and author,* Thirty Tomorrows *(Thomas Dunne Books, 2014)

Certainly debt relief would not help Europe's creditors. Not only would they suffer, but the general loss of wealth, however specific arrangements apportioned it, would impair Europe's overall investment prospects and with it, prospects for income growth and wealth creation. To the extent that debt relief injured creditors outside Europe, it would impair such prospects elsewhere as well. If governments socialized the losses, say by subsidizing banks and other creditors, the ill effects, falling then on the taxpayer, might unfold with less drama than otherwise, but Europe would suffer them nonetheless. Still, the damage might be worth it, if it bought time for essential reforms.

A fundamental change in financial policies would constitute one such compensating reform. Europe's periphery has its debt problems in large part because its nations for years borrowed beyond their ability to support the debt or repay it. There would be no debt crisis in the first place if they had behaved more responsibly. Unless they change this old fiscal approach, debt relief would have no lasting effect and would only set the stage for another crisis when a new accumulation of unsupportable debt built to troubling levels. That time would likely come sooner rather than later, because the losses imposed on creditors would limit the pool of future lenders.

The ill effects of relief would surely be worth it if they also bought time for these nations to implement fundamental economic reforms. This is no place to itemize the various rigidities in labor markets, product markets, and regulatory structures in Greece, Italy, Spain, and throughout Europe's periphery that impede business development, slow the pace of innovation, and hamstring the ability of these economies to use their workforces and other economic resources fully or effectively. Former Italian Prime Minister Mario Monti and current Prime Minister Matteo Renzi have called attention to such failings. Reform in these areas, by promoting growth and wealth creation, would not only give these nations a greater ability to carry debt, but it would also relieve these governments of their past need to borrow in order to support standards of living.

Without such measures, debt relief would destroy wealth to no purpose. The absence of such reform would also make pointless a temporary euro exit, for a one-time devaluation could have no lasting effect if these old practices continued to hold these nations back financially and economically, while it would further destroy wealth in the country that decided to do it. Unless the members of Europe's periphery can reform their economies to serve their citizens' needs on a sustainable basis, everything else is a gimmick, and debt relief is a painful one at that.

The eurozone needs to move toward a common fiscal policy.

HOWARD DAVIES
Professor, Sciences Po, and former Chairman, Financial Services Authority

For many economists, especially from North America, assessing the state of the eurozone economy entails passing through Alice's looking glass into a different world. Nothing is quite as it seems. There is no central fiscal authority. There are fiscal rules, but no one follows them. Such fiscal transfers as there are have little or no relation to the state of the economic cycle: they are mainly used to buy off powerful economic interests, such as the farmers.

And even after eighteen years of fixed exchange rates, we are no nearer to achieving a European economy. Indeed the euro has done very little to promote economic integration. Trade intensity within the zone has barely increased, and massive differences in productivity and earnings persist. The synchronicity of different EU economies has barely increased since the euro was introduced.

So any economic question like this one, which presupposes the existence of a European economy, is capable of several different answers. Of course Germany does not need debt relief. Of course Greece will never be able fully to repay all its debt.

Increasingly, the key division in the eurozone is between creditors and debtors, and that division is becoming more stark. Germany has passed a balanced budget law, at a time when a larger German deficit would assist the adjustment process needed in the South.

So rather than convening a debt conference, which would at best produce a breathing space for high-debt countries, the eurozone needs to move toward a common fiscal policy that provides the basis for cross-country flows which can offset asymmetric shocks. The early single currency blueprints in the 1970s envisaged a central budget of perhaps 2–3 percent of EU GDP which could be used for that purpose. Europe's leaders need to face up to the need to provide such a safety valve, or the single currency will continue to lurch from crisis to crisis.

Gurro-Bonds—now there's an idea.

JAMES GALBRAITH
Lloyd M. Bentsen, Jr. Chair in Government/Business Relations, LBJ School of Public Affairs, University of Texas at Austin, and a career-long meddler in financial crises, beginning with the rescue of New York City in 1975–76

By 1986, informed opinion knew that Third World debt would have to be reduced, written off, defaulted. The problem was to get official agreement to this fact. It was to effect a change not in thinking, but in the accepted thinking. This was the contribution of the 1986 Bradley-Kemp conference, organized by Richard Medley and David Smick, which I attended, happily at their expense.

Today, accepted thinking on European finance is centered on the Eurogroup. In these meetings of finance ministers, the Greek government can challenge and disrupt accepted thinking, but they can't change it. Insecure politicians are bound far more by past commitments than present realities; to admit error is to concede fallibility, and to concede fallibility is to invite the thought that the other fellow might do a better job. Finance ministers have no authority to concede this. Thus the vociferous hostility of Spain, Portugal, and Finland to concessions for Greece. And then there is the fact that inside the International Monetary Fund and the European Central Bank, power rests on programs, and careers depend on enforcing programs consistently, consequences be damned.

In 1986, the United States was the key creditor and Ronald Reagan could not have a third term, so even the transition to George H.W. Bush opened a path to change and debt resolution via Brady Bonds. Today in Europe it is not so easy to make a similar change. A debt conference held by the Eurogroup might achieve little. There must a prior change of ideas—and some way to project change onto governments that have an inherent tendency to stay the course to disaster.

There are four entities whose leadership does show signs of understanding that change is now necessary. They are the IMF, the European Commission, the government of Germany at least in the person of Chancellor Angela Merkel, and the OECD. The problem is (in part) that in the two cases that matter most, the IMF and Germany, there is institutional inertia, entrenched ideology, and the topmost leadership exercises less-than-perfect political control.

The OECD, though less influential, has the greatest mental flexibility. In April, Secretary-General Angel Gurría even hosted Greek Finance Minister Yanis Varoufakis, via the annual conference of the Institute for New Economic Thinking in Paris. Perhaps Mr. Gurría, who long ago managed Mexico's Brady Bonds, might take the lead here? Gurro-Bonds—now there's an idea.

Instead, try a one-time patrimonial wealth tax designed to cut outstanding public debt by a significant percentage.

EDWARD N. LUTTWAK
Senior Associate, Center for Strategic and International Studies

It is not just Europe that needs European debt relief but the entire world economy, now afflicted by fiscally depressed demand in Europe.

The attempt to deal with a stock problem—an excessive stock of public debt—with a flow solution has resulted in sharp tax increases and concurrent cuts in public investments (everything from R&D to highway construction) which depress both current demand and productivity gains.

At present, after years of stagnation marked by destructively high unemployment in several countries, there are definite signs of renewed growth, but there is very little chance of reaching even 2 percent annual growth rates because fiscal drag must persist under current policies.

Europe and the world would benefit immensely if the stock problem was instead addressed with a stock solution: a one-time patrimonial wealth tax designed to cut outstanding public debt by a significant percentage, say 50 percent. Arithmetically at least, that is definitely feasible, even in the case of Italy with its €2,228 billion of public debt as of today, given the high net worth of Italian households (there are 1.1 million Italian households with declared liquid holdings in excess of €1 million).

Politically, such a one-time wealth tax might become less unthinkable if accompanied by immediate tax cuts, and the prohibition of whatever form of excess is locally prevalent, such as very high salaries for public officials in Italy, government subsidies in Spain, and so forth.

There are many reasons not to take the patrimonial solution seriously. But the present course will ensure deeply demoralizing unemployment levels for years to come, with crippling demographic repercussions, while default would crown years of austerity for the sake of financial credibility with its opposite.

Forgiving public debt would be snatching defeat from the jaws of victory.

WILLIAM R. CLINE
Senior Fellow, Peterson Institute for International Economics

Forgiving public debt in the euro area periphery now would be snatching defeat from the jaws of victory. The ECB's announcement of Outright Monetary Transactions in mid-2012 provided the lender of last resort needed to defuse the euro area debt crisis. Now its quantitative easing is providing further help by reducing base interest rates and compressing spreads further. Sovereign risk spreads above German ten-year bunds have fallen from 2011–2012 peaks of 1,620 basis points in Portugal, 1,350 in Ireland, 760 in Spain, and 730 in Italy to 130, 50, 107, and 113 basis points respectively. My mid-2014 book, *Managing the Euro Area Debt Crisis,* developed a probabilistic debt projection method that takes account of correlations between good and bad states of baseline-flanking scenarios for growth, sovereign spread, primary (non-interest) surplus, privatization, and bank recapitalization. My probability-weighted projections showed the public debt-to-GDP ratio falling from a range of 121–133 percent in 2014 to 98–119 percent by 2020 in Ireland, Portugal, and Italy, and stabilizing at 107 percent by then in Spain. These governments are solvent.

Debt forgiveness is not costless. Fifteen years after Mexico received a haircut of only 35 percent in the Brady Plan, its rating was still only BBB-, whereas that of no-haircut Chile was A, a difference of 170 basis points on long-term dollar debt. Moreover, in economies such as that of Italy, the government mainly owes its own banks and citizens, so the national wealth windfall from debt reduction is far less than where debt is owed abroad. Those nostalgic for the debt-reduction tonic of the Brady Plan fail to take into account the fact that market prices of Latin American debt were far below face value, so the situation was ripe for exchanging principal reduction for risk-reducing guarantees. Today, market prices exceed face value of euro area debt contracted earlier at higher, pre-crisis interest rates.

Syriza's push for further debt reduction in Greece is mainly political, as the real burden of Greece's remaining debt is much lower than implied by the nominal debt ratio, thanks to concessional interest rates from European public creditors. It would be unfortunate if political contagion brought widespread calls for debt reduction in other periphery economies. Growth benefits from reducing a supposed debt overhang would be speculative, whereas long-term damage to credit reputation would be certain.

Debt relief should not be taken lightly.

MICHAEL J. BOSKIN

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European economies lag 30 percent or more behind U.S. living standards. High taxes and burdensome regulations stifle hiring and new businesses. Generous social welfare payments reduce incentives to work. Even with the slight pickup underway, chronic sluggish growth will not create sufficient opportunities for the masses of unemployed and underemployed, nor will it significantly dent public debt burdens. Europe's greatest need is stronger economic growth.

It is usually best to allow the parties to debt contracts to decide on any changes in terms and conditions. Debt relief should not be taken lightly, given the risk of encouraging irresponsible debtor behavior. But when excessive public debt becomes a serious, permanent drag on growth, carefully prescribed debt relief may be a useful part of a reform package to promote prosperity. Since the European Central Bank, the International Monetary Fund, and the European Union now hold most Greek debt, given the small size of the Greek economy, contagion risk is containable; not so for large, heavily indebted countries such as Italy.

Restoring prosperity and financial stability requires solutions to several inter-related problems. First, fiscal: Spending and taxes are too high, and many governments have failed to control spending growth, adding debt in order to postpone the reckoning.

Second, banking: Banks supply roughly 70 percent of the credit to European economies, compared to 30 percent in the United States. But some European banks are still capital-starved zombies kept alive by public infusions of liquidity.

Third, currency: The euro's benefits—cross-border pricing transparency, lower transaction costs, inflation credibility—require surrendering the independent monetary policies and flexible exchange rates that can help economies attenuate recession. With limited interregional transfers and labor mobility, Europe struggles to absorb disparate shocks. In the United States, by contrast, people in high-unemployment Michigan move to Texas, where jobs are plentiful, even as the federal tax and transfer system automatically shifts money in the opposite direction, cushioning the local downturn.

And fourth, governance: Citizens are increasingly disenchanted with European elites and supra-national institutions such as the European Commission, imposing rules and regulations that conflict with their countries' economic interests and sovereignty. Nationalist sentiment is rising, and demagogic parties of the far right and left are gaining in every poll.

The continent can move beyond its current torpor, beginning with gradual fiscal consolidation to scale back sclerotic welfare states—too many are collecting too-large benefits. Next is modest relief of a portion of the public debt of highly indebted countries. The zero-coupon "Brady Bonds" the United States used to resolve the Latin American debt crisis in the 1990s could be a model, perhaps with mutualized backing.

Third, rapid resolution of Europe's zombie banks by acquisition or temporary takeover, cleanup, and asset sale, as was done by the Resolution Trust Corporation during the U.S. savings and loan crisis in the 1980s, is needed. Fourth, further structural reforms would increase labor-market flexibility and reduce red tape for new business formation. Progress has been slow, with a few exceptions such as Spain.

Last, the eurozone should adopt a two-track euro with a flexible internal exchange rate, with clear rules determining when members of the eurozone are relegated to "euro B" or promoted to "euro A." This halfway house, "depreciation without departure," would limit many of the problems of a complete withdrawal from the euro.

Together, these policies would strengthen growth, reduce sovereign debt, lower interest costs, ameliorate tax pressures, enable depressed national economies to increase competitiveness with fewer sacrifices to living standards, and provide Europe with a road map to more permanent prosperity. It might well preserve the euro project from itself.

A debt relief program not accompanied by credible reforms will do positive harm.

CHARLES W. CALOMIRIS

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The "debt overhang" problem, which was formalized in financial economics in the mid-1970s, can apply both to sovereigns and corporations. When corporate debt exceeds the borrower's debt capacity, it distorts the borrower's decisions in ways that produce excessive risk-taking and reduced investment. Excessive sovereign debt has more far-reaching consequences because it creates risks for the whole economy (devaluation, capital flight, the inability to provide essential public services). Sovereign debt relief can have dramatic positive consequences for promoting growth. Debt restructuring can even be beneficial to creditors—reducing debt as part of a reform arrangement that increases the probability of repayment of the remaining debt can raise the market value of outstanding debt even as its face value is reduced.

There is no doubt that Greece, in particular, is desperately in need of debt relief as part of a package to promote growth. But debt relief alone will not solve Greece's problems, and a debt relief program for Greece that is not accompanied by deep and credible reforms will do positive harm both to Greece and to the rest of Europe. The harm to Greece would come from institutionalizing the waste and inefficiency of the current Greek economic model, which is based on rigid labor laws, anti-competitive business licensing, excessively generous pensions, featherbedding in government employment, and corrupt clientelist rent seeking. The harm to Europe would come from the precedent that a policy of debt forgiveness without reform would set, and the political consequences it would entail—most importantly for Spain, Italy, and France. In these countries, the desperately needed supply-side reforms on which the future of the eurozone depends would be undercut.

The way forward for Greece—which its current government has utterly failed to promote—is to offer real reforms in exchange for substantial debt relief. A Greek government proposal that would offer expenditure cuts, labor law flexibility, business licensing reform, and a credible anti-corruption program in exchange for significant debt relief and other short-term aid would be embraced by its European partners. That combination would offer a solution to debt overhang along with real hope for growth in Greece, and a helpful precedent for the rest of Europe. Don't hold your breath.

Has anyone mentioned the ECB?

HANNES ANDROSCH

Former Finance Minister and Vice-Chancellor of Austria

Debt is the life-blood of the economy because, without debt, there would be precious little economy. Too much debt, on the other hand, could be regarded as the cholesterol that can cause serious economic thrombosis. The eurozone now finds itself in intensive care, and the institutional reforms to date, no matter how desirable, address the symptoms, or consequences, rather than the deep-rooted cause of the problem.

Domestic financial crises have their origins in irresponsible monetary policy, frequently in support of misguided fiscal objectives. International financial crises are rooted in the balance of payments, specifically in persistent imbalances in the current (and capital) external accounts of systemically important countries. This idea is not new, but what is frustrating is the outright refusal of many to accept it. Germany, Japan, and China are the neo-mercantilists, or bullionists, with China at least having the valid excuse that it is going through a period of export-led development.

Current account surpluses lead to an increase in bank reserves, which have to be lent somewhere, inevitably abroad—again China is an exception as it eschews capital account convertibility, at least for the time being. By this token, the consumption-driven indebtedness of Greece, the property-bomb *malheur* of Spain and Ireland, and the protracted swan-song of some Austrian banks following their exuberant acquisition phase, are all different manifestations of the same problem.

It is not clear how this problem can be solved. Creditor countries insist on strict adherence to the legal conditions of loan contracts, and this does carry a certain logical plausibility, not to mention strong political appeal. But it lacks an overview of the international debt problem which, according to a recent McKinsey report on debt and deleveraging, deteriorated dramatically between 2007 and 2014.

The debt cannot be repaid, or even reduced to a tolerable level, at least probably not in the lifetime of anyone living today. So how can we avoid its worst repercussions?

Debt forgiveness has a certain appeal, if only because it creates a certain moral burden of gratitude on the part of the forgiven (hopefully). The alternative of driving a country into bankruptcy would almost certainly lead to debt repudiation, and create an intense sense of alienation without any prospect of a more successful outcome. The post-World War II solution of paying negative real interest is unlikely to succeed because the necessary inflation is prohibited and because savers today are economically more literate.

The bottom line is that the creditor countries are very likely to lose their external assets, one way or another. Until they do, the debt overhang will strangle any real prospect of economic recovery in the eurozone. In the sixteenth and seventeenth centuries, mercantilism frequently led to war; today, the maximum threat is known as Grexit. The greatest danger confronting the eurozone is one of collapse in the banking sectors of creditor countries, and we must try to avoid this by seeking a workable, reasonable, and above all sustainable redistribution of the burden.

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