THE BOSTON CONSULTING GROUP

Fixing the Euro Zone

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AT A GLANCE

Although a step in the right direction, the recent haircut imposed on private holders of Greek debt really only buys time. In order to reduce unsustainably high debt levels and improve the competitiveness of some member states, the euro zone needs to pool its excess debt in a region-wide redemption fund.

The Scope of the Euro Zone Problem

BCG estimates that the euro zone governments have excess debt in the neighborhood of €3.7 trillion. Nonfinancial corporations and households have an additional €1.4 trillion in excess debt.

Pooling Excess Debt

Pooling this €5 trillion in excess debt in a region-wide redemption fund would allow overindebted euro-zone governments to secure financing at much lower interest rates than are available today.

Necessary Structural Reforms

The redemption fund would be tied to a 20-year fixed repayment plan for each country, as well as a plan to increase growth and restore competitiveness in periphery countries.

The successful haircut imposed on private holders of Greek debt in early March 2012 has led some observers to conclude that the euro zone is finally on its way toward solving its debt problems.

The move followed the decision of the European Central Bank (ECB) in December 2011 to lower its core refinancing rate to 1 percent and, in cooperation with the U.S. Federal Reserve, to ease the borrowing of U.S. dollars for banks via foreign central banks. The ECB has also offered two new longer-term refinancing operations (LTROs) with three-year maturity dates. These steps have significantly reduced bank financing costs and improved the funding conditions for sovereigns in the euro zone periphery.[1] In response to the LTRO offerings, European banks borrowed €489 billion in December 2011 and a record €530 billion in February 2012.

In parallel, European governments have agreed to several measures to restore confidence in the euro zone. In addition to the decision in March 2011 to implement a permanent European Stability Mechanism (ESM) by June 2013, these measures comprise more stringent limits for structural deficits of the member countries, the close supervision of national budgets, and additional contributions to the International Monetary Fund (IMF).

Any long-term solution to the euro zone crisis has to reduce the debt overhang and restore the competitiveness of some countries.

Is the combination of these measures enough to solve the euro zone's problems? Unfortunately, we doubt it. These measures are really only a short-term fix. They fight the symptoms but do not cure the disease.

The real issue facing the euro zone is dealing with two fundamental problems: unsustainably high debt levels and the lack of competitiveness of some member countries.[2] The introduction of the ESM, the intervention of the ECB, and the reduction in Greek government debt can only buy time to address these broader issues. Any long-term solution to the euro zone crisis has to reduce the debt overhang and restore the competitiveness of some countries—notably Portugal, Greece, Spain, and Italy.

In previous papers, we have discussed alternative ways to address the euro zone's overindebtedness—introducing the concept of *financial repression* in which interest rates are kept below the nominal rate of growth in GDP—and pointed to the need for a possible debt restructuring financed through a wealth tax.[3] In this paper, we unveil a detailed proposal for how euro zone governments can reduce the debt overhang through a combination of financial repression and wealth taxes, following a euro zone–wide pooling of excess debt to reduce interest rates.

The Scope of the Euro Zone Problem

Euro zone governments have to acknowledge the necessity to substantially reduce the current unsustainable debt burden. Assuming that a government debt-to-GDP ratio of 60 percent represents the upper limit of sustainability,[4] there is an excess debt of €3.7 trillion that needs to be eliminated for the government sector alone.[5] (As a point of reference, the current Greek haircut reduced that nation's debt-to-GDP ratio from 160 percent to about 110 percent.)

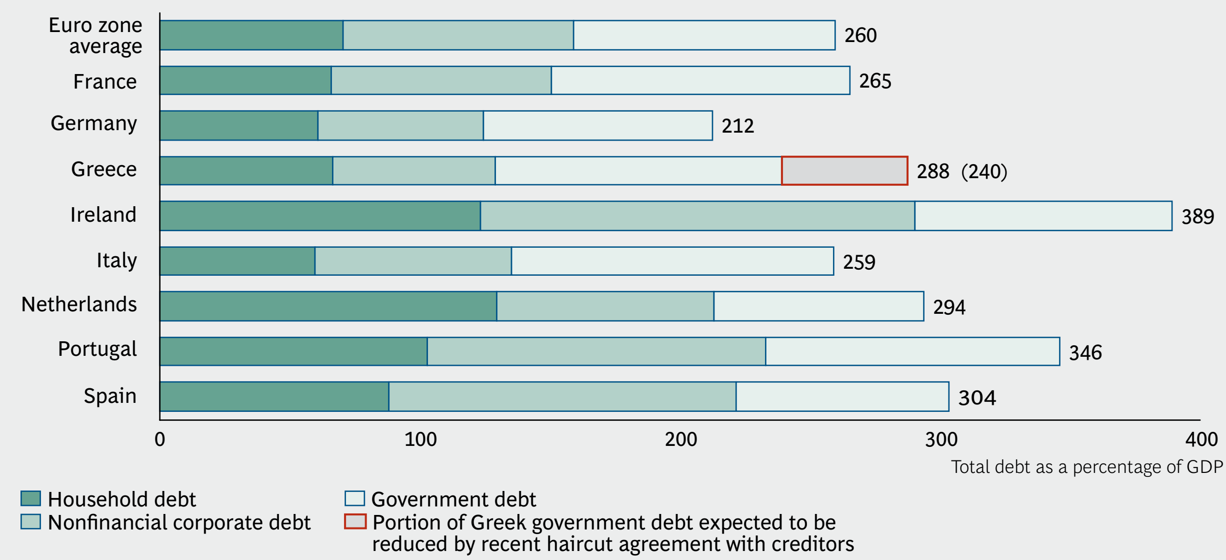
Euro zone countries do not just have a government debt problem. They have substantially over-leveraged private sectors that are also in need of restructuring.

But, of course, the euro zone countries do not just have a government debt problem. They have substantially overleveraged private sectors that are also in need of restructuring. Spain and Ireland, for instance, have a massive corporate debt problem; the Netherlands is suffering from high private-household debt. Since, unlike governments, both private households and nonfinancial corporations can reduce leverage on their own (given positive savings rates, corporate cash flows, and existing assets), we have set their debt-to-GDP sustainability threshold at 90 percent, which means that approximately €1.4 trillion will have to be restructured. (See Exhibit 1.)

Reducing such a vast debt burden will take time and will require unpopular measures. The usual ways of dealing with the debt overhang won't work in the current situation:

- *Saving and Paying Back.* Neither indebted countries nor overleveraged private sectors will be able to save more in order to pay back their loans. Should many debtors pursue this path at the same time, the ensuing reduction in consumption would lead to even lower growth, higher unemployment, and correspond-

Exhibit 1 | The Euro Zone Countries Have More Than Just a Government Debt Problem



Sources: Eurostat; European Central Bank; BCG analysis.
Note: Debt refers to nonconsolidated gross debt as of third-quarter 2011, with the exception of Greece (where the government debt is consolidated) and Ireland (where second-quarter 2011 data are used).

ingly less income, making it more difficult for other debtors to save and pay back. For the private sector and government to reduce debt simultaneously would require running a trade surplus.[6] But as long as surplus countries (China, Japan, and Germany) pursue export-led growth, and emerging markets do not import significantly more, it will be impossible for debtor countries to deleverage.

- *Growing Faster.* The best way to improve debt-to-GDP ratios would be to grow GDP faster. Historically, this has rarely been achieved and appears to be unlikely now. Growth prospects for developed economies are limited in a two-speed world in which growth has largely shifted to developing markets. Even with substantial structural reforms, growth opportunities are limited (the IMF estimates an additional growth potential of only about 0.5 percent for the euro zone on the basis of the "best-in-class" performance of euro zone peers).[7] Growth will also be hampered by the aging of Western societies, with the workforce in Western Europe shrinking 2.4 percent by 2020. Finally, debt in itself makes it more difficult to grow out of debt, because it reduces the ability and willingness for additional spending and investments.[8]

We propose that excess debt be pooled in a euro zone redemption fund that is tied to a specified repayment plan and accompanying structural reforms.

Pooling Excess Debt

In order to avoid default and to pursue orderly deleveraging, we propose that excess debt be pooled in a euro zone redemption fund that is tied to a specified repayment plan and accompanying structural reforms. Pooling excess debt and refinancing it as joint-liability issuers in the form of Eurobonds would allow over-indebted euro zone governments to secure financing at much lower interest rates. Excess government debt would be rolled in over several years as debt matures. The German Council of Economic Experts has made a sensible proposal for the structure of such a redemption fund.[9]

A pooling of government debt is relatively straightforward. It is less obvious how a restructuring of private-sector debt would take place. Nevertheless, a restructuring is clearly necessary in some countries and in some sectors. The likely alternative is widespread insolvencies with the resulting economic and social fallout. One option would be to force banks to take a haircut on debt for borrowers above a certain level of leverage. The resulting financing necessary to recapitalize the banks could be funded from the redemption fund.

In our proposal, the redemption fund would be tied to a 20-year fixed repayment plan for each country. Eurobonds would be issued with a matching, staggered maturity profile. The average annual cost for euro zone countries to repay the pooled debt over 20 years would be in the neighborhood of 2.4 percent of GDP (assuming slight financial repression, with nominal growth rates 1.5 percent higher than nominal interest rates).[10] Exceptions could be granted to smaller highly indebted countries (such as Cyprus) not considered here if these countries prove unable to shoulder additional obligations.

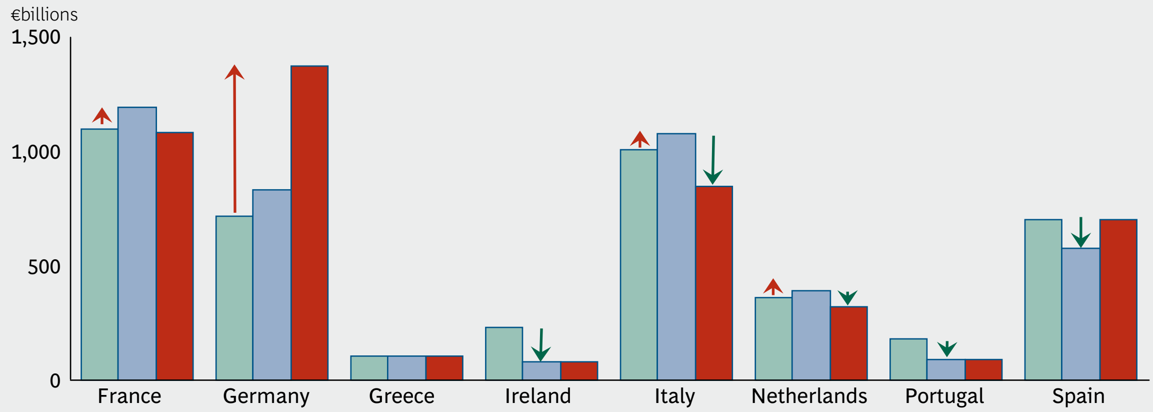
Such repayments would be financed by raising additional taxes, earmarked for payments to the redemption fund. One option would be a wealth tax, which, compared to other types of taxes (for example, an income or value-added tax), would be less likely to negatively affect growth. Such a tax could be justified politically as the realization of already existing losses on financial assets that are currently at risk of defaulting. Of course, the longer the time horizon, the more acceptable such a tax is likely to be. Given our time frame of 20 years, the wealth tax would require a relatively moderate tax on the financial assets of private households of about 1.2 percent per year (less if nonfinancial assets were also included).

Four Alternative Repayment Plans

Ideally, each country would be responsible for its own debt repayments (that is, in proportion to the debt rolled into the redemption fund). However, we expect that some countries—and, at a minimum, Greece, Ireland, Portugal, and Spain (the so-called GIPS countries)—will require support in meeting their payments, given their combination of high excess-debt levels and high government deficits. Some reallocation of repayment obligation may, therefore, be necessary. We propose four alternative repayment options.

Option 1: No Reallocation. Each country repays its own debt and its own debt only. (See Exhibit 2.) This approach would pose an extremely high burden on Ireland and Portugal. Ireland would have to pay approximately 5.8 percent of its GDP per year in loan repayments over the 20-year period, whereas Portugal would

EXHIBIT 2 | Reallocating Excess Debt to Strong Economies Will Help the Weak Ones Recover



	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain
Annual tax rate (as % of GDP)	2.5 2.7 2.4	1.3 1.5 2.5	2.4 2.4 2.4	5.8 2.1 2.1	2.9 3.1 2.4	2.7 3.0 2.4	5.3 2.7 2.7	2.9 2.4 2.4

Option 1: No reallocation
Option 2: Reallocate GIPS[1] debt
Option 3: Reallocate excess debt of all euro zone countries
Maximum additional debt allocated
Maximum debt reduction

Sources: Eurostat; European Central Bank; BCG analysis.
Note: Debt refers to nonconsolidated gross debt, with the exception of Greece (where government debt is consolidated). "Excess debt" is all debt above 60 percent of GDP for governments and above 90 percent of GDP both for households and for nonfinancial corporations. The analysis assumes that this debt is pooled and paid down by raising additional taxes. The horizontal gray bar shows the annual costs for each country under each scenario as a percentage of GDP, based on a 20-year repayment period and assuming an interest rate for pooled debt of 2.75 percent, euro zone inflation of 2.1 percent, and real growth of 1.7 percent plus an additional 0.5 percent following structural reforms (different growth forecasts are assumed for each country). Data are as of third-quarter 2011, with the exception of Greece (which incorporates the expected savings from the Greek haircut of €107 billion) and Ireland (where the data are as of second-quarter 2011).
[1]"GIPS" stands for Greece, Ireland, Portugal, and Spain.

have to pay 5.3 percent. Spain would also likely struggle given its continuing high government deficits. (The Greek debt burden has already been reduced in the recent restructuring.)

Option 2: Reallocate GIPS debt. The repayment obligations of the GIPS countries are reallocated to reduce their excess debt level to that of the euro zone average (54 percent of GDP). The reallocated debt would be shared by the other euro zone countries in proportion to their GDP. This approach would greatly relieve Ireland, Portugal, and Spain, while requiring only a moderate additional debt payment of about 0.2 percent of GDP per year in the other euro zone countries. Given its high excess government debt, Italy would bear the highest overall burden under this scenario, with payments of approximately 3.1 percent of GDP per year. We believe, however, that given the sizable financial assets of the Italian private sector, Italy will be able to resolve its debt problem independently. (Again, exceptions could be granted to smaller highly indebted countries if they proved unable to shoulder additional obligations.)

Option 3: Reallocate Excess Debt of All Euro Zone Countries. The total amount of excess debt is reallocated to all euro zone countries according to their GDP, and all of them repay a constant percent of GDP per year of around 2.4 percent, to be raised through dedicated taxes (the choice of tax left to each individual country). The necessary tax rate would differ slightly among member countries, depending upon expected GDP growth rates. This approach would ensure that all countries have an equal, bearable burden, but high-GDP countries (most notably Germany) would end up paying considerably more than others.

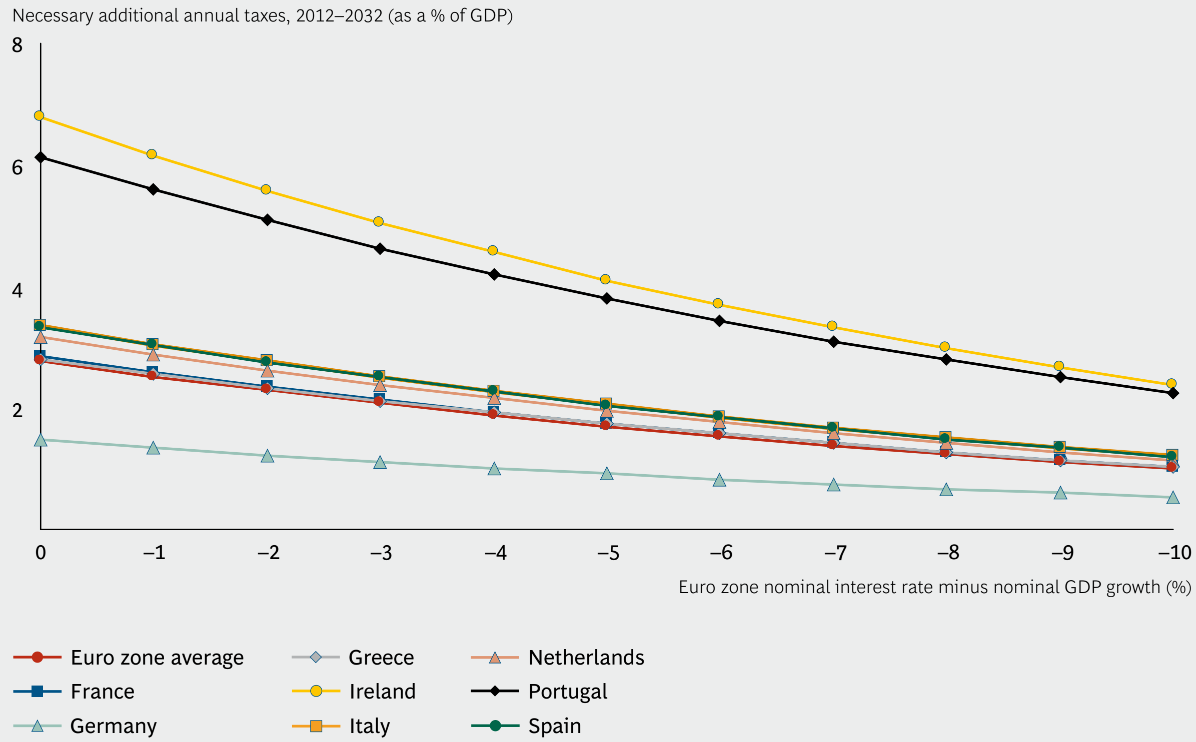
In the end, the choice of reallocating payment obligations is a political one. The chosen approach has to balance the needs of the weak with the willingness of the strong.

Option 4: A Euro Zone Wealth Tax. Necessary repayments of reallocated debt according to the size of each euro zone country's GDP are financed through a euro zone–wide wealth tax of around 1.2 percent on private household financial assets. This option would leave government budgets unaffected and ensure equal treatment of citizens (if not countries) across the euro zone.

Our analysis assumes nominal growth rates of 1.5 percent above nominal interest rates, a mild degree of financial repression. Additional financial repression, most likely achieved by increasing inflation, could substantially reduce the debt-service costs for euro zone countries. For example, increasing nominal growth by 7 percent would cut the required payments to the redemption fund by more than half, provided that investors are forced to accept low interest rates owing to regulation and capital controls. (See Exhibit 3.)

In the end, the choice of reallocating payment obligations is a political one. Whatever approach is chosen, it has to balance the needs of the weak with the willingness of the strong. In order to make the repayment plan credible, it would need to be coupled with firm limits on new indebtedness and government deficits, beyond those agreed upon at the European Union's December 2011 summit. Such a commitment would also make agreement on the debt restructuring more acceptable to the richer northern countries. Any reallocation of repayment obligations would be contingent on the relieved countries' adherence to the agreed-upon limitations—under penalty of having the obligations revert back to the original borrowers.

Exhibit 3 | Financial Repression Strongly Impacts How Much Each Country Has to Pay



Sources: Eurostat; European Central Bank; Economist Intelligence Unit forecasts; BCG analysis.
Note: This analysis assumes that "excess debt" (all debt above 60 percent of GDP for governments and above 90 percent of GDP both for households and for nonfinancial corporations) is pooled but not reallocated among euro zone countries and paid down over 20 years by raising additional taxes. The interest rate for pooled debt is assumed to be 2.75 percent, forecasts for euro zone inflation 2.1 percent, and real growth 1.7 percent, plus an additional 0.5 percent growth following structural reforms (a different growth forecast is assumed for each country). Data are for third-quarter 2011, with the exception of Greece (which incorporates the savings from the Greek haircut) and Ireland (where the data are from second-quarter 2011).

We have had numerous discussions with European economists, policymakers, and government representatives about the practicalities of such a restructuring plan. It is clear that there would be formidable legal and political hurdles—both at the European level and in each participating country—to debt pooling and to the assumption of massive additional liabilities. However, given the benefits to all participating countries and the fact that the alternative is likely to be the breakup of the euro zone itself, these obstacles are well worth tackling.

Necessary Structural Reforms

A substantial debt restructuring such as the plan described above is a prerequisite to enable euro zone countries to return to stable growth. Debt restructuring will need to be accompanied, however, by a comprehensive plan to increase growth and restore competitiveness of the periphery countries. This plan must include lowering unit labor costs and introducing more flexibility into labor markets.

The plan should also include a combination of higher inflation (to facilitate wage adjustments while helping to reduce real debt) and higher consumption in the northern countries. Employees in Italy, Spain, and Portugal (and also France) would have to accept wage increases below the rate of inflation, while employees in Germany and the Netherlands would enjoy real-wage increases. Reducing southern euro zone trade deficits would also require a rebalancing of global trade flows, in particular through a shift in emerging markets to more domestic consumption.

No Alternative

Saving the euro will be a very expensive exercise. But without such restructuring of debt and fundamental reforms, we foresee significant political tensions and the risk of disorderly exits of countries on the periphery of the euro zone.

It would not be the first time in history: exits from currency unions are quite frequent—more than 100 such events were documented in the second half of the twentieth century.[11] Such exits, combined with a clean balance sheet after defaulting, often provide the basis for new growth and fiscal balance. Historically, countries that defaulted (such as Argentina, Indonesia, and Russia) have usually returned to strong medium-term growth within one to two years after defaulting.[12] A breakup of the euro zone, however, would lead to devastating consequences—what the OECD has recently described as "massive wealth destruction, bankruptcies, and a collapse in confidence in European integration and cooperation," leading to "a deep depression in both the existing and remaining euro area countries as well as in the world economy."[13]

The creditor countries have to accept that they will lose money under any scenario. The debt is too large to pay back. These countries do, however, have the option of choosing precisely how they will lose their money—whether through defaults and economic chaos, sizable inflation, or orderly restructuring and joint responsibility.

Given these alternatives, we believe our proposal for pooling excess debt is the best option for governments and the best way to avoid a long period of low growth, high unemployment, and continuous political tension. It might be the only option for keeping the euro zone intact.

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NOTES

1. See Nick Vause, et al., "European bank funding and deleveraging," *BIS Quarterly Review,* March 2012.
2. See *Collateral Damage: What Next? Where Next? What to Expect and How to Prepare,* BCG Focus, January 2012.
3. See *Collateral Damage: Stop Kicking the Can Down the Road; The Price of Not Addressing the Root Causes of the Crisis,* BCG Focus, August 2011, and *Collateral Damage: Back to Mesopotamia? The Looming Threat of Debt Restructuring,* BCG Focus, September 2011.
4. This number is based on the assumption of a stable debt ratio with a 5 percent interest rate, 3 percent nominal growth, and balanced primary budgets. The 60 percent debt-to-GDP ratio is also one criteria of the Maastricht Treaty.
5. Note that debt figures are based on third-quarter 2011 nonconsolidated debt numbers as reported by Eurostat, with the exception of Greece (where the government debt is consolidated) and Ireland (where second-quarter 2011 data are used).
6. For a detailed explanation of the relationship between domestic deleveraging and trade balance, see *Collateral Damage: In the Eye of the Storm—Ignore Short-Term Indicators, Focus on the Long Haul,* BCG White Paper, May 2010.

7. IMF Staff Position Note, "Lifting Euro Area Growth: Priorities for Structural Reforms and Governance," November 22, 2010.

8. Studies by Carmen Reinhart and Kenneth Rogoff and the Bank for International Settlements show that once government debt reaches 90 percent of GDP, the real rate of economic growth is reduced. This threshold also applies to the debt of nonfinancial corporations and private households.

9. German Council of Economic Experts, Annual Report 2011/2012.

10. Our scenarios assume the interest rate for pooled debt to be 2.75 percent, euro zone inflation to be 2.1 percent, and euro zone real growth (following structural reforms) to be 2.2 percent. Different growth rates are assumed for each country on the basis of forecasts by the Economist Intelligence Unit.

11. See Volker Nitsch, "Have a Break, Have a . . . National Currency: When Do Monetary Unions Fall Apart?" CESifo Working Paper No 1113.

12. See "Default, Exit and Devaluation as the Optimal Solution," Variant Perception, February 2012.

13. *OECD Economic Outlook,* Volume 2011/12 (Preliminary Version)—Chapter 1, "General Assessment of the Macroeconomic Situation."

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