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Trying to Win the European Confidence Game

By Raghuram Rajan

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If there is any solution to the European crisis proposed over the next few days to restore confidence to the sovereign-bond markets, it will have to be both economically viable and politically palatable to rescuers and rescued alike. This means paying attention not just to the plan's technical details but also to appearances.

There is growing consensus about any solution's key elements. First, Italy and Spain will have to come up with credible medium-term plans that will not just restore their fiscal health, but also improve their ability to grow their way out of trouble. While any plan will involve pain for citizens, the markets must deem the pain politically tolerable, at least relative to the alternatives.

It is important that these plans be seen as domestically devised, although voters will have no illusions about the external and market pressures that have forced their governments to act. At the same time, an external agency such as the International Monetary Fund could render the plan more credible by evaluating it for consistency with the country's goals and monitoring its implementation.

Second, some vehicle — the IMF or the European Financial Stability Facility, with either entity funded directly by countries or the European Central Bank — has to stand ready to fund borrowing by Italy, Spain and any other potentially distressed countries over the next year or two. But there is an important caveat, which has largely been ignored in public discussions: If this funding is senior to private debt, as IMF funding typically is, it will be harder for these countries to regain access to markets. After all, the more a country borrows in the short term from official sources, the further back in line it pushes private creditors. That makes private lenders susceptible to larger haircuts if the country eventually defaults — and thus more hesitant to lend in the first place.

In other words, private markets need to be convinced both that there is a low probability of default — hence the importance of credible plans — and that there is some additional loss-bearing capacity in the new funding, so that, if there is a default, outstanding or rolled-over private debt does not have to bear the full brunt.

This may seem unfair. Why should the taxpayer accept a loss when they are bailing out the private sector by providing new funding? In an ideal world, distressed countries would default as soon as private markets stopped funding them, and they would impose the losses on private bondholders. In the real world, however, if Italy and Spain are viewed as being solvent, or too big to fail, official funding should be structured so that it gives these countries their best chance to regain market confidence.

This does not mean that official funding should be junior to private debt in any restructuring because that would require substantially more loss-bearing capacity from the official sector — capacity that is probably not available. Indeed, if official funding were junior, it would be providing a larger cushion to private creditors — and thus bailing them out to an even greater extent.

The simplest solution is to treat official funding no differently from private debt — best achieved if official lenders buy sovereign bonds as they are issued, possibly at a predetermined yield, and agree to be treated on par with private creditors in a restructuring. As the country regains market confidence, the official funding can be reduced, and eventually the bonds can be sold back to the markets.

The bottom line is that official funding must be accompanied by loss-bearing capacity. If the funding is channeled through the IMF and is to be treated on par with private debt, the fund will need a guarantee from the European Financial Stability Facility or strong euro-zone countries that it will be indemnified in any restructuring. Of course, the IMF's member states might be willing to accept some burden-sharing if a sufficient buffer provided by the euro zone were eroded, but that cannot be taken for granted.

Once the first two elements of the plan are in place, there should be little need for the third — bond purchases by the European Central Bank in the secondary market to narrow interest-rate spreads and provide further confidence. Indeed, if the European Central Bank intends to claim preferred-creditor status for any bonds that it buys, it is probably best that it buy very few. Of course, it will have to continue to provide support to other banks until confidence about their holdings returns.

But there is one more element that is needed to assure markets that the solution is politically viable. Citizens across Europe, whether in rescued countries or rescuing countries, will be paying for years to clean up a mess for which they were not responsible. Not all banks voluntarily loaded up on distressed government bonds — some were pressured by supervisors, others by governments — but many have made unwise bets. If they are seen as profiting unduly from the rescue, even as they return to their bad old ways of paying for nonperformance, they will undermine political support for the rescue — and perhaps even for capitalism.

So a final element of the package ought to be a monitored pledge by euro-zone banks that they will not unload bonds as the official sector steps in; that they will raise capital over time instead of continuing to deleverage; and that they will be circumspect about banker bonuses until economies start growing strongly again. Cries that this is not capitalism should be met with a firm retort: "Nor are bailouts!"

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