NET Institute*

www.NETinst.org

Working Paper #11-01

January 2011

Trichet Bonds To Resolve the European Sovereign Debt Problem

Nicholas Economides and Roy C. Smith
Stern School of Business, NYU

* The Networks, Electronic Commerce, and Telecommunications ("NET") Institute, http://www.NETinst.org, is a non-profit institution devoted to research on network industries, electronic commerce, telecommunications, the Internet, "virtual networks" comprised of computers that share the same technical standard or operating system, and on network issues in general.

Trichet Bonds To Resolve the European Sovereign Debt Problem

by Nicholas Economides* and Roy C. Smith**

January 2011

* Professor of Economics, Stern School of Business, New York University, NY 10012; (212) 998-0864, economides@stern.nyu.edu.

** Kenneth Langone Professor of Entrepreneurship and Finance, Stern School of Business, New York University, NY 10012; (212) 998-0719, rsmith@stern.nyu.edu.

Trichet Bonds To Resolve the European Sovereign Debt Problem

by Nicholas Economides and Roy C. Smith

Executive Summary

We propose the creation of "Trichet Bonds" as a comprehensive solution to the current sovereign debt crisis in the EU area. "Trichet Bonds," to be named after the ECB president Jean-Claude Trichet, will be similar to "Brady Bonds" that resolved the Latin American debt crisis in the late 1980s and were named after the then Treasury Secretary Nicholas Brady. Like the Brady Bonds, Trichet Bonds will be new long-duration bonds issued by countries in the EU area that will be collateralized by zero-coupon bonds of the same duration issued by the ECB. The zero-coupon bonds will be sold by the ECB to the countries issuing Trichet Bonds, which will be offered in exchange for outstanding sovereign debt of the countries. The exchange is offered at market value, so current debt holders will experience a "haircut" from par value, and thus the exchange does not involve a "bailout." However, present holders of sovereign debt will be exchanging low quality bonds with limited liquidity, for higher quality bonds with greater liquidity. Debt holders not accepting the exchange will be at risk of a forced restructuring at a later date at terms less favorable. The effect of the exchange offer, if a threshold of approximately 70% approve it, is to replace old debt with a lesser amount of new debt with longer maturities.

The creation of Trichet bonds will result in various advantages both in comparison to the present unstable situation and other proposed solutions. First, the long duration of Trichet bonds will eliminate the immediate crisis caused by short term expiration of significant amounts of debt which is looming over Greece, Ireland, Portugal, Spain and possibly other EU countries. Second, the guarantee of the principal with the zero-coupon ECB bond collateral increases the quality of the Trichet Bonds compared to existing sovereign debt. Third, the market for the new Trichet Bonds will be liquid and likely to trade at appreciating prices as refinancing (roll-over) risk is reduced and time is allowed for economic reforms by the issuing countries (a condition of the ECB) to take effect.

In addition, the exchange of existing sovereign debt for Trichet bonds will force many European banks holding the sovereign debt to take the write-offs required, thus making their own balance sheets more transparent. Many European banks are thought to have large holdings of sovereign debt from the "peripheral" countries that have not been marked-to-market, and thus represent

sizeable potential losses for the banks when the sovereign debt is ultimately restructured, as we believe it must be over the next few years. Most of the sovereign bank debt likely to be exchanged, however, is held by larger German, French and Swiss banks with the capability (if not necessarily the desire) to take the write-offs required. The overhang of such future losses affects the entire European banking system at a time when it too is being restructured. The ECB, and the European central banks need to identify those banks that are impaired by excessive sovereign holdings and assist them in recapitalization – the sooner the better – but they should also push the larger, stronger banks to accept the exchange offers in the interest of bank transparency and restructuring as well as in resolving the sovereign debt problem. Clearly the two problems – sovereign debt and bank restructuring – are connected. The issuance of Trichet Bonds, will help to resolve both problems by recognizing market realities and offering an easier way out than through a forced, cram-down restructuring once the ailing sovereigns exhaust their ability to repay the existing debt.

There are significant advantages to Trichet bonds over other discussed solutions to the sovereign debt problem. One such proposed solution is the issuance of "Euro Bonds" guaranteed by the Eurozone countries or the EU itself for the purpose of redeeming sovereign bonds by market purchases, or by lending the proceeds to the countries involved for them to acquire their debt. Apart from the considerable political obstacles to such a program, the undertaking actually makes it less likely that existing self-interested debt-holders will sell in the market. The implication of the program is that either through market interventions that push prices up, or by the assumption that the program will continue to enable the debt to be retired at par on maturity, debt-holders won't sell unless the price is pushed high enough to constitute a bailout. The ECB's current efforts to support the prices of distressed sovereign bonds is currently having this effect, which transfers some, if not all of the cost of resolving the problem to European taxpayers, where increasingly it is resented.

The alternative approach, that has only been discussed by market participants, is for a Russian or Argentine solution in which the debt-holders are made a take-it-or-leave-it offer to exchange outstanding debt for new, generally illiquid bonds at an arbitrary price that discourages future investment by the market. Such an approach is understood by the sovereign debt market to constitute a *de facto* default. Such a default would likely have serious adverse consequences for the Euro and the EU, and may be less likely that a bailout of some kind.

The great advantage of Trichet Bonds is that they avoid both bailouts and defaults.

Keywords: Trichet bonds, sovereign debt, euro, debt restructuring, Greece, Ireland, Portugal, Spain, Italy, Brady bonds

JEL Classification: G01, G10, G20, G28

1. Introduction

As the EU sovereign debt crisis is in its second year, the lack of an accepted mechanism to deal with it is becoming dangerous to the integrity of the Euro and the EU itself.

Several EU member countries found themselves in severe economic straights as the 2008 banking crisis and the ensuing recession forced them to face liquidity crises arising from a number of long term problems that were accentuated and made more severe. The EU (together with the IMF) has established a €750 billion "rescue fund" to alleviate the problems of certain member countries in meeting their debt repayment obligations. So far it has dealt with the debt crisis on a case by case basis, even though the problems are systemic as exhibited daily by the volatility of financial markets. Countries like Greece were given a short term breathing space through loans and support, but will have to face the almost impossible task of borrowing from the financial markets in late 2011 onwards. Ireland will have to restructure its banks before its sovereign debt can be faced. The rescue fund will guarantee (meet the maturities of debt coming due) through midyear 2013, but after that the EU has not pledged to extend the facility to countries deemed to face "solvency" as compared to "liquidity" problems. The market does not know how to foretell the difference, and therefore assumes all will be insolvent in 2013, and then face unknown consequences. In the meantime, the political price to be paid by the establishment of the rescue fund, and its implied €750 billion taxpayer-financed bailout, is facing considerable resistance within Europe. As a result, distress sovereign bond spreads are now at record levels, in many cases exceeding the spreads paid by bonds from emerging market countries.

Without a workable EU remedy for the sovereign debt problems, countries like Portugal, Spain and Italy are being treated by the market, which so far has ignored the European rescue fund and related efforts to calm the crisis, as potential defaulters. This could lead to some countries being forced by financial markets to "restructure" their debt (under the circumstances this would be effectively defaulting on their outstanding obligations) with potentially catastrophic consequences for those countries as well as for the future of the Euro and the EU.

We propose a solution that is similar to the "Brady Bonds," used to prevent default in a number of Latin American countries. In the mid-1980s, Mexico and a number of other Latin American countries faced debt crises. In 1988, Mexico offered to exchange its debt obligations with new bonds that were collateralized by a thirty-year zero-coupon US Treasury bond. New bonds were issued by Mexico at market prices reflecting a discount of about 30% at which the old bonds were trading. Seventeen Latin American and other countries followed the initiative with similar plans. The bonds became known as "Brady bonds" after Nicholas Brady, then US Treasury Secretary. [1] Similarly we proposed the creation of "Trichet bonds" to be issued by distressed EU-area countries.

[1] Approximately $200 billion of Brady Bonds were issued by 18 countries in the 1990s.

2. Trichet Bonds

Trichet bonds will be long-duration (30-year) new bonds issued by countries in the EU featuring a 30-year zero-coupon bond issued by the ECB, to be held as collateral for the new sovereign bonds, to insure at least the full payment of principal at maturity. The new bonds are to be issued at market interest rates, but will be offered for old debt at market value (now about 65-70% of face value). Present debt holders will face a significant haircut (of the order of 30-35% for Greece and Ireland) because new bonds will be sold/exchanged at present market prices. Because the bond exchange will occur at present prices, there is no bailout associated with Trichet bonds.

The countries issuing the Trichet Bonds will purchase the zero-coupon collateral bonds directly from the ECB. They may be able to apply some of their reserves held by the ECB for this purpose, or otherwise enter into an appropriate financing package with the ECB. But the idea is that the ECB is not to subsidize the country purchasing the zero-coupon bonds for use as collateral supporting the Trichet Bonds.

3. Features and Advantages of Trichet Bonds

There are multiple advantages of the creation of Trichet bonds and their exchange with existing sovereign debt, and these have been observed with the Brady Bonds experience.

a. Trichet Bonds Removes Uncertainties as to Refinancing Distressed Countries' Maturing Debt.

The long duration of Trichet bonds removes the immediate crisis caused by short term expiration of significant amounts of debt which is looming over Greece, Ireland, Portugal, Spain and possibly other EU countries. Trichet bonds allow distressed countries to defer maturities over a longer period and to effect economic reforms before having to return to capital markets on the basis of their own credit-worthiness. Trichet Bonds will enable sovereigns to see bond spreads be reduced considerably from their record levels at present. Extension of repayment makes interest payments more manageable and default risk much smaller.

b. Trichet Bonds Will Be of Much Higher Quality Than Present Sovereign Debt of Distressed Countries

The Trichet Bonds will be perceived as being of higher quality than the debt being exchanged, encouraging existing debt holders as well as arbitrageurs to make exchanges, and creating the opportunity for the bonds to rise in price after the exchange.

c. Trichet Bonds Will be Liquid

The market for the new Trichet Bonds is likely to be liquid, unlike the present markets for sovereign bonds of countries under distress. Liquidity for Trichet bonds may be further enhanced by the fact that they could be issued for a number of countries and thus become a "class" of debt sought by investors.

d. Trichet Bonds Require No Bailout and Imply No Moral Hazard

Much of the resistance in debt restructuring comes from the fear that restructuring will effectively be a bailout by countries of tighter fiscal discipline to countries with less fiscal discipline, and the moral hazard that this implies. The fear is that countries' "bad" behavior in overspending and accumulating debt will be rewarded through a government bailout. In contrast to such a restructuring, there is no bailout associated with Trichet bonds. Old bonds will be exchanged at present market prices. The debtor does not receive higher value than what the present bonds are worth other than modest incentives designed to encourage participation in the exchange.

e. Trichet Bonds Provide Debt Relief for Distressed Economies

Besides exchanging large short term for long term obligations, the exchange into Trichet bonds directly reduces debt obligations of debtor countries because the exchange is done at the present value of the bonds, giving them sufficient breathing room in the short and medium run.

f. The Exchange is Voluntary and Beneficial to Both Countries and Debt Holders

We have described in detail the benefits to the distressed countries of issuing Trichet bonds. There are also significant benefits to the bond holders which provide incentives for them to accept the voluntary swap. Bond holders will receive in a Trichet bond a higher quality bond than will be easily traded in a liquid market. The debt holder EU banks may be able to do the swap in Trichet bonds for the sovereign debt they hold in their capital accounts without writing the marked-to-market loss in their books, thereby escaping bankruptcy.

4. Comparison of Trichet Bonds With Other Solutions

Presently the EU and ECB do not have a mechanism to deal with anything but the most severe, acute, and immediate aspects of the crisis. Two other possible solutions have been discussed, and we show below that they are both inferior to the Trichet bonds solution we propose.

The solution proposed by European authorities so far involves the ECB's purchase of outstanding sovereign debt in the market, which has only succeeded in buying a small amount of the distressed debt while pushing bond prices upwards as a result of the intervention. The Rescue Fund has advanced a sizeable amount of money to Greece and Ireland and has guaranteed all debt maturing before July 2013 without relieving the pressure on bond spreads at all. The market is hesitant, with sellers reluctant to realize losses that might be avoided by a future bailout, and buyers reluctant to bet on the bailout occurring.

A proposal to issue "Euro bonds" guaranteed by the Eurozone countries or the EU has not improved bond spreads either. There is considerable doubt as to whether the proposal will be able to attract enough political support to occur, and, if it does, how it will be any different from the intended support mechanisms of the ECB's market purchases efforts or the availability of money through the rescue fund. The question of whether bailouts are to occur after 2013 has not been answered.

5. Concluding Remarks

The present reality of the situation is that the ability of other, larger sovereigns to roll over maturing debt on their own is increasingly in doubt, and in any event, will involve very high, economically penalizing, interest rates.

Under these circumstances, one or more sovereigns may be unable to issue new debt to redeem old debt at par value in the future. If this happens, and the Rescue Fund does not provide taxpayer funds to meet the maturity at full value, the sovereign will be forced into default – that is, it will be forced to restructure with a unilateral offer of new debt for old. This will be the event that the EU dreads, that could undo the entire structure of the EU. There has to be a better way to deal with the problem – using Trichet Bonds appears to be a better way.