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Global

Global Economics View

The euro area recovery starts with Cyprus

- Depositors of Cypriot banks are to be 'bailed in' in all but name, pending the passing of emergency legislation by the Cypriot parliament.
- In our view, this course of action is qualified good news for the euro area, in that it is a decisive step to restructure excessive levels of (in this case bank) debt which is necessary for the return to sustainable growth in the euro area. Future restructurings of bank debt and sovereign debt (both official sector involvement and private sector involvement) in the euro area are to follow.
- Some near-term costs are likely, as some – perhaps previously complacent – investors reassess the risks of debt restructuring of euro area banks and sovereigns, and because the agreement in Cyprus strengthens the perception that the euro area approach to reducing excessive debt in sovereigns and banks is rather ad-hoc and sometimes relatively unpredictable. We think it would have been desirable: i) for insured depositors (below €100k) to be spared, ii) for haircuts on larger deposits to be made bigger to satisfy the entire recapitalization need of the banks, and iii) for losses to reflect recapitalization needs of each bank.
- Contagion risks are overrated, in our view. The risk of bank runs in other euro area countries has clearly risen, but the unique features of the Cypriot situation should limit the 'read through' to other cases in the euro area. Even when bank runs occur, the ECB has the means to substitute for the funding lost from departed deposits.
- To make the bank and sovereign debt restructurings more orderly, a common euro area resolution mechanism and authority, and a statutory sovereign debt restructuring mechanism should be created.

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The euro area recovery starts with Cyprus

Cypriot depositors have been 'bailed in', in all but name

Emergency legislation still needs to be passed by the Cypriot parliament for agreement to be implemented

If enacted, several implications follow for the further evolution of the euro area sovereign debt and banking crisis:

- **private creditors are likely to make a major contribution to the deleveraging of excessively indebted banks and sovereigns in the euro area**
- **nature of creditor involvement will vary on a case-by-case basis**
- **governments likely will try harder to protect sovereign creditors than bank creditors**

On Friday night, the Eurogroup announced that depositors of Cypriot banks will be 'bailed in', even though use of the word 'bail-in' was carefully avoided in all official statements.[1] The troika programme and loan package still has to be ratified by the Cypriot parliament. Ratification is by no means assured. The ruling coalition has only 28 out of the 56 parliamentary seats, and some MPs have already stated that they would vote against. This is one reason the government has imposed a bank holiday until next Wednesday (Monday is an official holiday). The vote originally planned for today, has apparently been postponed until tomorrow. A negative vote would likely result in a disorderly sovereign and bank default in Cyprus. Although that would be devastating for Cyprus, the small size of the Cypriot economy makes it unlikely that there would be systemic repercussions for the rest of the euro area.

In our view, a number of implications for the future development of the euro area sovereign debt and banking crisis follow from the agreed course of action, once the emergency legislation has been passed. In particular, this episode highlights that creditors are likely to make a major contribution to the deleveraging of excessively indebted banks and sovereigns (as well as non-financial businesses and households in some cases) in the euro area. In the case of bank creditors, this means that both subordinated unsecured creditors and senior unsecured creditors are at risk. In exceptional circumstances, of which Cyprus is an instance, even depositors – including small and supposedly insured depositors – can be bailed in. In the case of sovereign creditors, NPV haircuts for both private sector creditors (so-called private sector involvement or PSI) and NPV haircuts for official creditors (official sector involvement or OSI) are on the cards.

Prior statements by euro area national political leaders, European Commission officials and central bankers that, after the unique and exceptional case of Greece, there would not be any further PSI and that senior unsecured bank creditors would be safe are not credible. The same politicians and officials promised after all that the Greek sovereign would not default on its debt and that, when it became apparent that such a default would in fact happen, this would not constitute a credit event. The then President of the ECB, Jean-Claude Trichet, was emphatic about the need to avoid a credit event.[2] The European Union Economic and Monetary Affairs Commissioner Olli Rehn even described a Greek sovereign credit event as a "Lehman Brothers catastrophe".[3] Both statements turned out to be wide off the mark.

The political forces of austerity fatigue in the periphery and bail-out fatigue in the core, combined with the inexorable logic of debt sustainability dynamics make it all but inevitable in our view that further PSI and bail-ins of senior unsecured bank creditors (most likely excluding small depositors) are going to be a key part of the resolution of the euro area crisis.

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[1] See http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136190.pdf. We have previously expected the bailing in of depositors in Cyprus and thought it desirable (the two are unfortunately not always correlated).

[2] "I have already said what our message for those who are in charge was, and that message was: no credit event, no selective default, no default. That is the message of the Governing Council.", Jean-Claude Trichet, "Introductory statement to the press conference (with Q&A) Frankfurt am Main, 7 July 2011, **http://www.ecb.int/press/pressconf/2011/html/is110707.en.html**

[3] Euro Rallies on Trichet Endorsing "Debt Rollover" Plan for Greece, **http://au.ibtimes.com/articles/158655/20110607/euro-rallies-on-trichet-endorsing-debt-rollover-plan-for-greece.htm#.UUY6LFePdU0**

The nature and scope of this involvement of creditors depends on a variety of financial, political, and legal considerations and will probably vary on a case-by-case basis. Not all creditors are equal, however. What the Cypriot case indicates is that, in general, euro area governments will try harder to protect sovereign creditors than to protect bank creditors. That does not mean that creditors of excessively indebted sovereigns will escape unscathed, but it will make it less likely that sovereigns will be brought down by taking on the burden of bailing out insolvent banks. In the Cypriot case, further debt restructuring for bank creditors and sovereign creditors appears plausible, as the current bail-out looks unlikely to ensure the solvency of the Cypriot banks and sovereign.

It would be misleading to read the bail-in of depositors in Cyprus as a sign that policymakers in the euro area are more willing to involve depositors than other bank creditors, notably other unsecured (junior and senior) bank creditors. Bail-ins of deposits, and in particular of the uninsured portion of deposits – though in Cyprus even the insured deposit will be hit – may be on the table more generally, but the fact that they were chosen in the Cypriot case has more to do with the fact that other bank debt outstanding was too small to make a meaningful contribution, that much was issued under English law, and considerations about the ownership of some of the deposits. We expect that any future euro-area-wide or EU-wide legislation may well make depositors senior to other senior unsecured creditors.

Some deposit outflows – maybe even bank runs – are likely in other euro area countries, but contagion risks and effects are often exaggerated

The treatment of depositors in Cyprus is likely to lead to deposit outflows – probably even bank runs – in Cyprus as well as in other euro area countries where either there are both excessively indebted banks and fiscally weak sovereigns (the EA periphery) or simply excessively indebted banks (in most of the EU including the EA 'core'). But the risk of such contagion is often overrated, in our view, as the ECB has the means to replace departed deposit funding with its own funds (for fundamentally unwarranted contagion, i.e. solvent banks). In fundamentally warranted cases (i.e. for insolvent banks), the right policy option is to recapitalise the banks as quickly as possible by bailing in senior unsecured creditors first. If necessary, we think domestic taxpayers and, eventually, euro-area taxpayers generally should contribute to the recapitalisation, if the banks are systemically important and there is not enough unsecured creditors' debt to restore the banks to good financial health even with a full bail-in of all unsecured creditors. The alternative to bailing in bank creditors is in any case even less appealing – sovereign debt restructuring or 'zombie banks'.

On balance, we regard bailing in depositors in Cyprus as qualified good news for the euro area

On balance, we regard bailing in depositors in Cyprus as qualified good news for the euro area. We would have preferred that insured depositors (those with deposits less than €100k) be spared, with a higher levy on larger deposits to make up the difference. Indeed, we would have preferred a sufficiently high levy on the larger deposits (and other senior unsecured creditors, mostly senior unsecured bond holders) to take care of all the likely capital needs of the Cypriot banking sector, estimated at around €10bn, rather than the €5.8bn targeted by the depositor bail-in. But in a euro area where any kind of bold initiative is a rare bird indeed, this senior bank creditor bail-in is important because it creates a precedent that we expect to be emulated many times in the next few years, despite the assertions of the troika that Cyprus is unique and the senior unsecured bank creditor bail-in will not be repeated.

The Cypriot bank creditor bail-in is a net positive for the euro area, first, because it paves the way for more extensive debt restructuring of excessively indebted banks as well as other private sector entities and sovereigns. Such accelerated debt restructuring is necessary for the euro area to return to sustainable growth soon – without risking a lost decade to follow the lost half decade since 2008. Second, the Cyprus depositors bail-in is also good news politically, as it will limit additional bail-out fatigue in EA creditor countries and avoids putting the burden of bailing out investors

to an even more unbearable extent on taxpayers and beneficiaries of public spending in debtor countries. Third, the bank creditor bail-in improves the creditworthiness of the Cypriot sovereign compared to the alternative where an additional €5.8bn worth of bank recapitalisation demands were to land on the public sector balance sheet. Other sovereigns in Europe will find their creditworthiness improved (at the same time that banks' creditworthiness is further impaired) if markets perceive a greater likelihood of unsecured bank creditor bail-ins rather than taxpayer rescues of unsecured bank creditors.[4] However, there are also likely some near-term costs. Some of these will stem from investors correcting mistaken beliefs about how far crisis resolution had gone in the euro area. In addition, the approach taken in Cyprus is not ideal, both by applying the same losses to depositors of institutions with different capital needs and by involving insured deposits and also contrasts with previous protestations about protecting depositors. Investors may see a lack of predictability in some aspects of the approach of EA policymakers to resolve the crisis, which may, at the margin, hurt their appetite for investment, until more clarity emerges.

In our view, more bank debt and sovereign debt restructuring are needed in the EA. To make that process as speedy and orderly as possible, institutional progress is needed. In particular, national and EA/EU-wide special resolution regimes for banks should urgently be implemented, including an EA-wide bank resolution fund. To prepare for the likely future cases of sovereign restructuring, a statutory sovereign debt restructuring mechanism should also be developed. Giving the ESM the option to recapitalise banks directly would also be a welcome ingredient to making the process of restructuring the insolvent parts of the European banking sector more orderly.

Bank depositors in Cypriot banks have been bailed in

The bail-in of depositors will be achieved through a 6.75% levy on deposits of Cypriot banks of less than €100k and a 9.9% levy on deposits equal to or in excess of €100k

Friday's deal envisages the bail-in of depositors will likely be achieved through a 6.75% levy on deposits of Cypriot banks of less than €100k and a 9.9% levy on deposits equal to or in excess of €100k, although the Cypriot government is discussing different rates of 3% and 12.5%. Deposits will also receive equity in the banks as compensation. Depositors of Greek branches of Cypriot banks will not be included in the levy. The troika estimates that this levy will make a €5.8bn contribution to the programme, which otherwise would have come in at around €17.5bn (100% of Cyprus GDP). The levies are to be withdrawn from bank accounts before banks reopen on Wednesday (Monday is a bank holiday in Cyprus and an additional bank holiday has been declared on Tuesday). [5]

The bail-in of the Cypriot depositors appears to have come as a surprise to many. It is true that, since World War II, bail-ins of senior unsecured bank creditors have been few and far between in the EU, and that depositor bail-ins were viewed as quite inconceivable because of supposed contagion-triggered bank runs (which we consider below). It is worth pointing out, however, that the very existence of deposit insurance and deposit guarantees (up to a common EU limit of €100k but with nationally funded/back deposit guarantee schemes) ought to have provided a strong hint that any deposits over €100k are not guaranteed and are therefore at risk. In any case, we view the role of limited deposit insurance more as 'widows-and-orphans' protection than as a tool for preventing bank runs.

[4] However, this does not mean that yields on sovereign debt will necessarily fall, as the risk of sovereign debt restructuring, including the risk of having to bail out insolvent, did not appear to be adequately priced in many countries in the euro area, in our view.

[5] In addition to the Cypriot parliament passing legislation to implement the deposit levy, the full bail-out agreement will require approval by the European Council and a number of European parliaments, and, should the IMF contribute to the bail-out, by the IMF board.

Deposit haircut of deposits of less than €100k is a surprise

There are two somewhat surprising features to this depositor bail-in. The first is that deposits less than €100k in size will be haircut also. €100k is the limit of the deposit insurance scheme all EU member states are supposed to implement. Bailing in supposedly insured deposits suggests that the Cypriot deposit insurance fund may not be capable of protecting depositors up to the insured limit. It would, in our view, have been better to raise the levy on the larger deposits and to leave the smaller deposits untouched.

The second surprise is the relatively modest size of the haircut on the larger deposits (even given the bail-in of the small depositors). The €5.8bn contribution to the Cypriot banking sector and sovereign adjustment programme that the deposit bail-in is supposed to make is unlikely to cover the capital deficiency (likely to be at least €10bn) in the banks' balance sheets (more than 7 times the size of Cyprus's annual GDP and hit hard by exposure to Greek sovereign debt and Cypriot real estate). If the balance of the banks' capital needs is to be met by the Cypriot sovereign, the solvency of the sovereign would appear to be at material risk. A larger up-front contribution from depositors would probably have made more sense, as it is likely that the market will consider the new Cypriot programme to be underfunded and will anticipate a further depositor haircut in the not too distant future. The one universal lesson for minimizing the systemic damage caused by bail-ins is: if a bail-in is highly likely to be required and if the markets anticipate its future occurrence, better to do it right away. Once a future bail-in is viewed as likely by the markets, the entity to be bailed in will not be able to fund itself in the markets any longer and any sources of funding that are withdrawable on demand on a first-come-first served basis are bound to head for the exit immediately.

Deposit levy does not look like it will be deemed a credit event

It looks as though, by imposing a haircut on depositors through a tax or levy, rather than through a write-down of the face value of the deposits, the Cypriot bail-in will neither be a credit event triggering CDS on Cypriot bank debt, nor a default for the rating agencies. Whatever the lawyers may decide, economics sees through the formal labeling of events and looks at their financial and economic consequences. An X percent specific capital levy on depositors passes the 'Duck Test' for a default: the creditors take an unambiguous hit equivalent in NPV to a reduction in the face value of their deposits by X percent.

It was clear to for some time that, barring a significant injection of concessional funding from parties other than the troika, say from east of Belarus, Cyprus would have to bail-in either the creditors of its banks or its sovereign creditors or both.[6] Because, without taking on the bad assets of the Cypriot banking sector, the Cypriot sovereign is most likely solvent, so it clearly would have made sense, from both a fairness and an efficiency perspective, to bail-in the senior unsecured creditors of the banks. However, in Cyprus, senior unsecured bond holders and other non-depositor unsecured creditors are scarce. Hence, the bail-in of the depositors.

The contagion myth

The argument most frequently made against bailing in senior unsecured creditors (SUCs) in general and depositors in particular is that it: (a) would make it difficult or even impossible for the Cypriot banks to fund themselves unsecured in the future and (b) that it would, through contagion, make it difficult or even impossible for banks in other euro area (EA) member states to fund themselves. Specifically, there would likely be deposit runs out of banks in countries with weak banks and weak sovereigns – out of the periphery of the EA, that is.

[6] See Euro Economics Weekly - Cyprus – Some Form of Debt Restructuring Looks Increasingly Likely

We consider these contagion fears to be exaggerated as regards their likelihood, their scope and scale and their wider financial and economic significance. Most contagion warnings appear to be no more than special pleading by exposed creditors. With apologies to Dr Samuel Johnson, we view contagion warnings as the last refuge of a scoundrel.

Will there be deposit flight from the periphery and indeed from Cyprus itself, after the Cypriot depositor haircut? Probably, yes. Will it by systemically damaging? Most likely not.

Future deposit flight from Cyprus is likely, because the size of the haircuts is, in our view, unlikely to restore the Cypriot banks to solvency. Further haircuts are therefore likely. The anticipation of future haircuts causes deposits to run. If the Cypriot sovereign, following the current haircuts, were to take over the bad assets of the Cypriot banks, the banks would be in the clear, but the sovereign would be at risk of a future sovereign debt restructuring.

As regards bank runs in other EA member states, these are certainly plausible, too. After all, a taboo has been broken in Cyprus. Not only have bank SUCs been bailed in, depositors have been bailed in. This was not part of the EU 'guide to banking' except in Denmark (an EU member but not an EA member) which bailed in the SUCs and the uninsured depositors of two small banks during 2012. Even Denmark did not bail-in the insured depositors.

Whether there will be contagion beyond Cyprus, depends (a) on how many banks are viewed as vulnerable, undercapitalised or insolvent but still alive thanks to lender forbearance, regulatory forbearance and the Eurosystem's willingness to fund likely insolvent banks (directly or through national ELAs) that offer as collateral securities issued or guaranteed by most likely insolvent governments, and (b) how many likely insolvent banks in the jurisdictions of most likely solvent sovereigns are likely not to be bailed out by their sovereigns, either for financial or political reasons.

Bailing in bank SUCs will become part of normal practice for the recapitalisation of systemically important banks that are undercapitalised but don't have access to market capital

Considering these criteria, there could be contagion through deposit runs and general unwillingness of any unsecured creditors (UCs) to extend credit to banks, throughout the periphery and in the core. Haircuts on bank UCs below the senior level are already part of the policy arsenal (e.g. Ireland in 2010, Spain in 2012 and 2013, and the Netherlands in 2013). Bailing in bank SUCs will become part of normal practice for the recapitalisation of systemically important banks that are undercapitalised but don't have access to market capital, and we believe will do so soon, well before the 2018 date the European Commission appears to have in mind for this and probably even before the 2015 date that the new Eurogroup Chairman, Jeroen Dijsselbloem, has proposed.

Cyprus is unique in a number of respects, limiting the likelihood and likely scope of contagion

Few other EA countries, however, are in the Cypriot position that almost all the SUCs are depositors. None have bank balance sheets in excess of 700% of annual GDP. One also hopes that none have the reputational shadow of money laundering, tax avoidance and tax evasion hanging over them, as has been reported in the widely leaked report by the German secret service BND on the subject.[7] There are banks in Spain and in Greece that have few SUCs other than depositors, but in most EA member states, the risk of bank creditor haircuts/bail-ins would seem to be limited to unsecured subordinated creditors and senior unsecured creditors other than depositors. Certainly insured depositors are highly likely to be kept whole everywhere outside Cyprus.

[7] See e.g. the report in the German magazine 'Der Spiegel', http://www.spiegel.de/international/europe/german-spy-agency-says-cyprus-bailout-would-help-russian-oligarchs-a-865291.html

The deposit runs may also be contained because of the exceptional composition and provenance of Cypriot creditors – which gave rise to the reputational problems already referred to. Such runs, as will occur, are unlikely to be systemically significant as the ECB can provide substitute funding for the departing deposits for as long as required.

Dealing with contagion if and when it occurs

The right policy response to any threat of contagion is clear. If contagion is fundamentally warranted, that is, if the banks affected by a deposit run would be at high risk of insolvency even if they were able to fund themselves on terms that did not reflect a material risk of insolvency, the optimal policy response is to restructure the banks in question as soon as possible. This would require wiping out the existing equity and recapitalizing the banks through the bailing in of unsecured creditors, starting with the most junior ones and progressing up the seniority scale up to the point that the banks are adequately capitalised.

If contagion is not fundamentally warranted, but instead merely represents the self-fulfilling 'bad equilibrium' outcome, in which high default risk premia trigger default even though there also exists a good equilibrium outcome where low default risk premia support the absence of any material default risk, then again the right policy response is obvious: let the ECB/Eurosystem act as lender of last resort to the banks in question, supporting them until those expecting their demise, or their risk officers, run out of patience and ammunition. The ECB has the resources to play this role, as no-one can defeat a determined ECB when euro-denominated funding capacity is the issue.

The role of bank deposit insurance in preventing a run will inevitably be limited. Even if we get a mutualised European bank deposit guarantee facility (which we think is still unlikely even in the medium-term), its coverage will be limited to deposits of €100k. Anything larger and withdrawable on demand would still run if it views itself at risk. Making up through central bank funding for the funding lost through a bank run is a more sensible course of action in our view than extending the deposit guarantee to all deposits so as to prevent bank runs completely.

Why the bailing in of Cypriot depositors is qualified good news for the Eurozone

From a Eurozone-wide macroeconomic perspective, the Cypriot bank depositors' bail-in is good news, as it brings closer large-scale deleveraging through debt restructuring in the EA.

From a Eurozone-wide macroeconomic perspective, the Cypriot bank depositors' bail-in is good news, as it brings closer large-scale deleveraging through debt restructuring in the EA. Sustainable growth will not return to the EA until banks, sovereigns and, in quite a few member states, households have deleveraged materially. Deleveraging through growth is not an option in the Eurozone, as even though fiscal austerity is likely to become less frantically pro-cyclical than in the past, the minimal unavoidable fiscal and private austerity required for the restoration and maintenance of financial sustainability by sovereigns, banks and the non-financial private sector is bound to keep real GDP from catching up swiftly with potential GDP.[8] Absent much greater immigration and widespread structural reforms, the growth rate of potential output in the euro area is also likely to be mediocre at best, probably not more than 1%pa.

[8] See Euro Economics Weekly - Fiscal Compact: A Structural Straight-Jacket

Deleveraging through inflation, either through unanticipated inflation or through anticipated inflation with financial repression, will also fail to make an impact on excessive debt and credit in the euro area. The ECB will not, in our view, deliver inflation systematically higher than about 2% per annum on the HICP measure. This is not just because of the Treaty and the ECB's numerical interpretation of the price stability mandate, but also – and indeed principally – because for the ECB the defining moment of central banking history is different from what it is for the Fed and other Anglo-Saxon central banks. For the Fed, the defining moment of central banking history is the Great Depression of the 1930s and the way in which central banks contributed to this catastrophe through perversely restrictive monetary policies. For the ECB, in the continental European tradition, the defining moment of central banking history is the catastrophe of the Weimar hyperinflation. This represents a fundamental difference in outlook, philosophy and likely policy practice. The ECB will not produce, although it could technically do so, sufficient inflation to achieve a material deleveraging of sovereigns, banks and households. We understand the reluctance of the ECB to contemplate using the inflation tax (anticipated and/or unanticipated, with or without financial repression) to restore sustainable debt and credit positions. It is easy to understate and underestimate the economic, social and political costs of inflation after a couple of decades of low inflation.

That leaves austerity (public and private), debt mutualisation and debt restructuring as the remaining mechanisms for removing excessive leverage as the key domestic demand obstacle to growth in the EA. We believe that there will be some of all three of these during the next three to five years, with austerity and debt restructuring playing the major roles. Debt mutualisation 'through the front' door, that is, through an enhancement of the euro area fiscal facilities (e.g. the ESM) or through the issuance of E-bonds or euro bonds that make the 17 sovereigns of the euro area jointly and severally responsible for debt service is likely to be 'de minimis'. E-bonds in particular, whether to replace existing national sovereign debt or to fund (part of) future national sovereign deficits will not be part of the resolution of this crisis. At best, it will be a component of the toolkit for addressing future euro area sovereign debt crises, at least a decade into the future – most likely more.

Some mutualisation of public debt and (indirectly) of bank debt through the ECB/ Eurosystem will undoubtedly take place, in our view. The ECB/Eurosystem has taken on its balance sheet around €205bn of periphery sovereign debt through the SMP (the now defunct Securities Markets Programme). It will likely take on additional sovereign debt through the OMT when countries like Ireland and Portugal (as part of their attempts to regain full access to the capital markets) or Italy and Spain (if they are at risk again of being frozen out of the capital markets) request access to its facilities. In addition, as already noted, the ECB has a significant indirect exposure to euro area sovereign debt through its loans to banks of questionable solvency that are secured against debt issued or guaranteed by periphery sovereigns. We expect that the ECB will take material losses on this exposure, although not enough to either exhaust its non-inflationary loss absorption capacity (NILAC, estimated by us to be around €3 trillion) or to prevent the need for sovereign bank debt restructuring in the periphery and bank debt restructuring throughout the euro area – core as well as periphery.[9] We believe any attempt to push the ECB to take losses close to (let alone above) its NILAC will risk triggering a comprehensive break-up of the euro area through an exit of the hard core, which would create a greater DM zone.

[9] Global Economics View - Looking into the Deep Pockets of the ECB*

Without recourse to debt restructuring for sovereigns in much of the periphery, of banks throughout the EA and of households in at least a few EA member states, the restoration in the EA of debt burdens to levels compatible with renewed domestic demand growth could take a decade – a lost decade.[10]

The first Greek sovereign default broke the taboo on sovereign debt restructuring in the euro area. Others will likely follow. We expect to see several more examples during the years to come of both OSI (NPV haircuts for official creditors of periphery sovereigns) and PSI (NPV haircuts for private creditors of periphery sovereigns). In Cyprus, the euro area is now breaking the taboo on bailing in senior unsecured creditors of banks. We expect to see many more examples of this, both in the periphery and in the core of the euro area.

Recognising that a view of the world and a strategy based on it have become untenable is the beginning of wisdom. The euro area political leadership is at last ready to put senior unsecured bank debt on the table, as a candidate for debt restructuring. This is an important step, long overdue, in the direction of a comprehensive deleveraging through debt restructuring of banks, sovereigns and, in some countries, households.

A move towards a euro area bank resolution facility and a euro area sovereign debt restructuring mechanism would be important for resolving the EA sovereign debt and banking crisis

It is important to build on this by accelerating the move towards a euro area bank resolution facility and a euro area sovereign debt restructuring mechanism. We believe the modus operandi of the euro area bank resolution mechanism should involve three steps. When a bank is insolvent, all its unsecured creditors, other than insured depositors are bailed in first. Second, if this still leaves a capital deficiency and if the bank is deemed systemically important, the national taxpayers are bailed in for ‘legacy bad assets’, that is, bad assets taken on while national regulatory and supervisory regimes were in effect. Third, if the resources of the national taxpayers are insufficient to fill the banks’ solvency gap and these banks are systemically important, the other euro area taxpayers are bailed in through a mutualised direct bank recapitalisation scheme.

The euro area sovereign debt restructuring mechanism (SDRM) should go beyond the contractual, market-based initiatives like the CACs (collective action clauses) introduced for some, but by no means all, newly issued euro area sovereign debt since January 1, 2013. There should, in addition, be a statutory dimension to the SDRM that can enforce a swift resolution of conflicting debtor and creditor claims and that cannot be challenged in national euro area courts but only at the European Court of Justice.

Accelerated deleveraging through bail-ins of senior unsecured bank creditors of insolvent banks, sovereign creditors of insolvent sovereigns and household creditors of insolvent households is a necessary step toward removing the demand-side obstacles to sustained growth of output and employment in the euro area.

[10] See Citi GPS: DEBT OF NATIONS - Mr Micawber’s* Vindication: Causes & Consequences of Excessive Debt, Willem Buiter and Ebrahim Rahbari, November 2012, Citi Research

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Appendix A-1

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