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An Anatomy of Debt Emancipation: A Proposal for an Interest Moratorium

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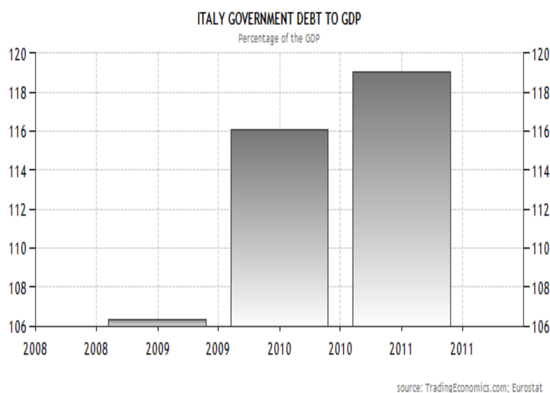
Can we live without interest payments for awhile for the sake of restoring confidence and stability in the markets? In ancient times when debts became unaffordable, a debt reduction was initiated to relieve pressure from those who could no longer afford the payments. The concept was known as seisachtheia.

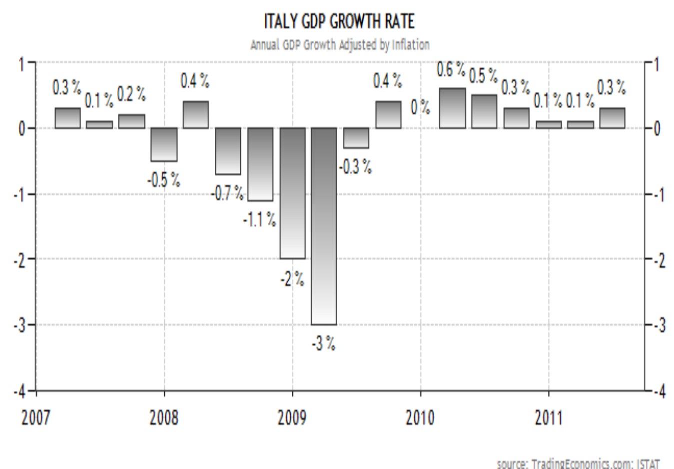
When society at large came to a dead-end, the affairs of the city-state were entrusted to a sage who instituted a form of benevolent dictatorship in an attempt to resolve the situation. That person was known as Aisimnitis. Last December we wrote about the need for such an Aisimnitis – see our commentary on December 13, 2010 - as we were assessing the situation in the EU and predicting the tremors that have shaken the markets in the last several months.

Let's look at some hard economic facts of two major EU economies and contemplate what such a moratorium on interest payments would do to those economies and to the markets. Let's start with Italy.

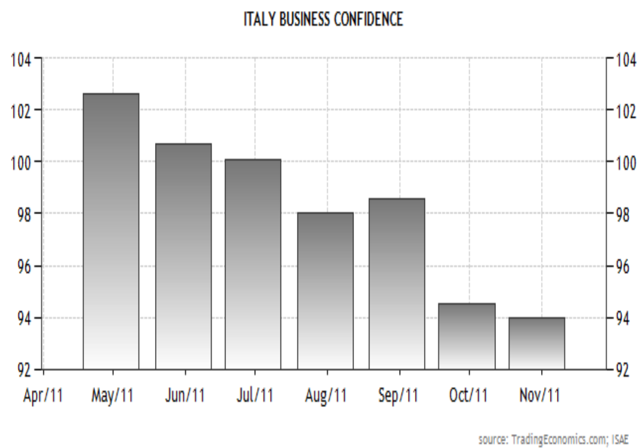


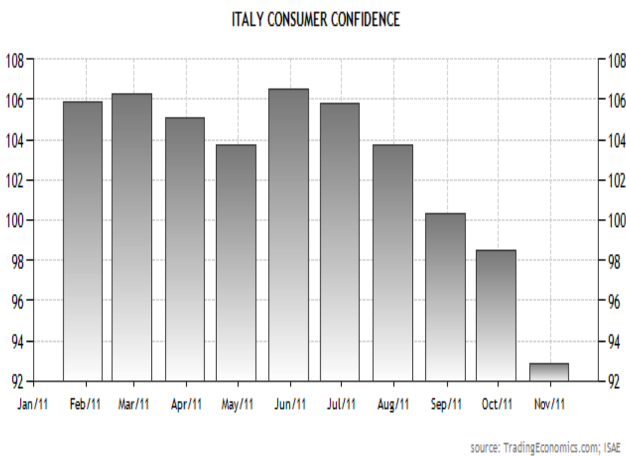
Italy, along with the US, and other major economies tried to stave off the deleveraging and deflationary forces that potentially could have led to depression by bailing out banks and picking up the tab of spending and stimulating their economies. Hence, the increases in deficits were added to existing debts making the latter unaffordable for Italy and its citizens. Needless to state that this story was repeated across the developed and less-developed world (China faces tremors, as we have explained in some of our other postings, due to the fact that it over-extended loans for projects that had minimal if any cash flow for debt service).

The countries instead of treating the causes (namely over-collateralization and over-securitization of questionable paper "assets" and of derivatives) chose to treat the symptoms. At the same time they left the institutions responsible for creating the problems untouched. Prudent advisors were calling for the breakup of these major banks. The results were overblown budgets, persistent deficits, global trade imbalances, deleveraging, contagion, uncertainty and a flight to safety, while the economies (in this case the Italian) suffered from stagnation, as the following figures shows.



As stagnation prevailed, business and consumer confidence declined, sales and profits suffered and a vicious cycle started.





Countries cannot afford to pay 5-7% interest rates when their growth rate is so dismal. Such dismal growth increases long-term cyclical unemployment (see graph below) and becomes the seed of political and social instability.

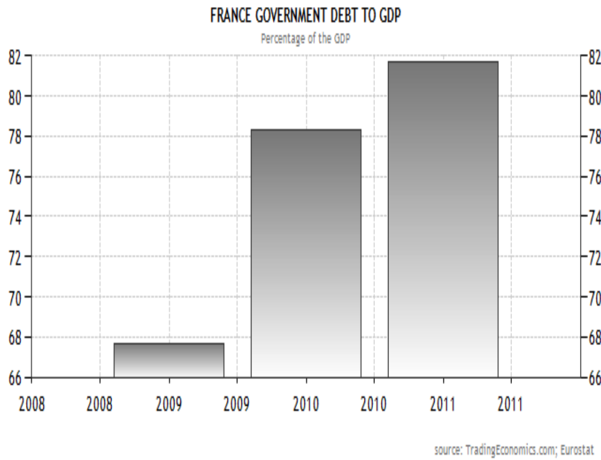
Italy's debt is about €1,800 billion. At a 6.5% interest rate, Italy needs close to €117 billion every year just for interest payments. Italy's annual deficit is about €90 billion. With the austerity that has already been introduced and a moratorium on interest payments, Italy would have a primary surplus (revenue-expenditures net of interest payments) in its budget within a year. The amount of interest payments would be applied to principal. The result would be a significant reduction in its debt over a course of five years. The consequences would be immediate relief, sustainable debt levels, lower yields on bonds, minimization of the risk of collapse, the Euro zone will be given breathing room to make structural and institutional changes, millions of jobs will be saved, confidence will re-emerge for businesses and consumers, the markets will calm down, social instability will be avoided, internal devaluations – through measures that have already been undertaken - will restore some competitiveness and thus trade imbalances will start the restoration process, while investment spending will start recovering too, given the avoidance of collapse. Of course, we cannot neglect the fact that accrued interest won't be credited for the bondholders (banks, pension funds, and individual investors) and new paper may not be able to be circulated, however we consider these costs much lighter than the costs of total market collapse that is emerging nowadays.

The moratorium we are proposing will actually also achieve the discipline that the Germans want since the inability to circulate new bonds will force countries to live within their means.

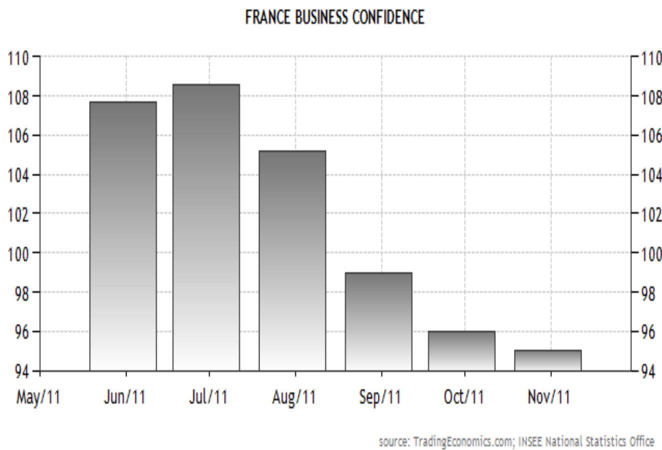
Let's now examine what is happening to France. As we have demonstrated in previous essays the French spread against the German Bunds is at historic Euro zone levels. France has been warned that it may lose its AAA rating (actually, given that France has the worst level of public and private debt throughout the EU, i.e. much worse than Greece, Italy, Portugal, Spain, Ireland, Belgium, etc., we are very surprised it has not yet lost its AAA rating). If France loses its AAA rating, the EFSF (EU's bailout fund) will also lose its AAA rating and that will have EU-wide consequences for yields, spreads, ability to finance and refinance debt, let alone for employment, business confidence, the banking sector, and growth prospects.

The following figure shows France's debt to GDP ratio. The story is familiar and resembles that of Italy. The French government resorted to bailouts, band aids and treatment of symptoms, allowed systemic risks to

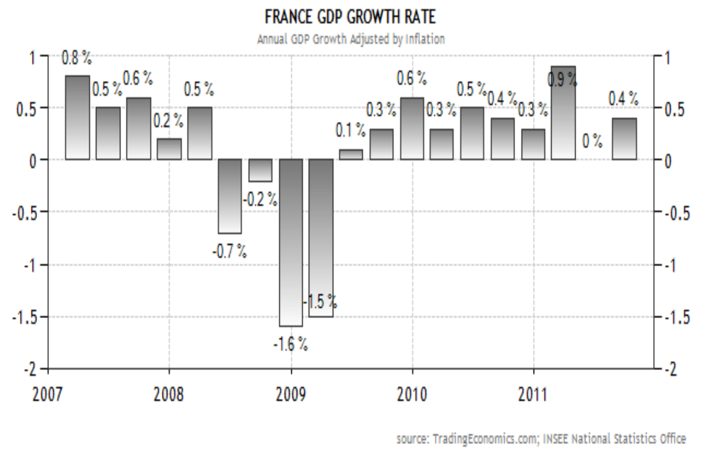
be built into the banking sector, while it did not take the proper measures to restore business confidence.



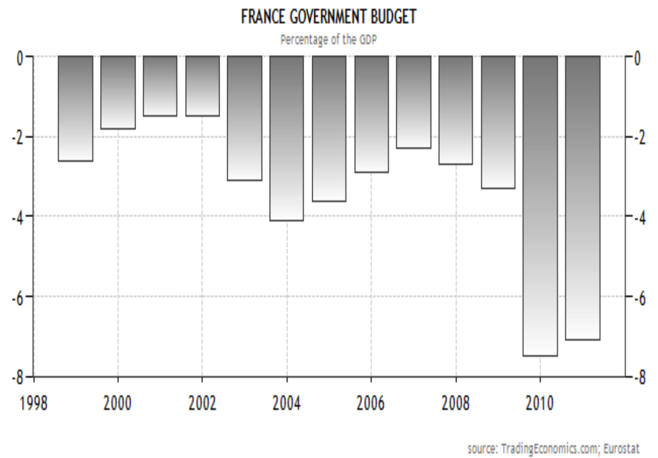
The result of kicking the can down the road was that as business confidence deteriorated in 2011, France was unable to move away from the debt trap. As months passed by it became apparent that the debt may not be affordable, especially given its dismal record of growth.

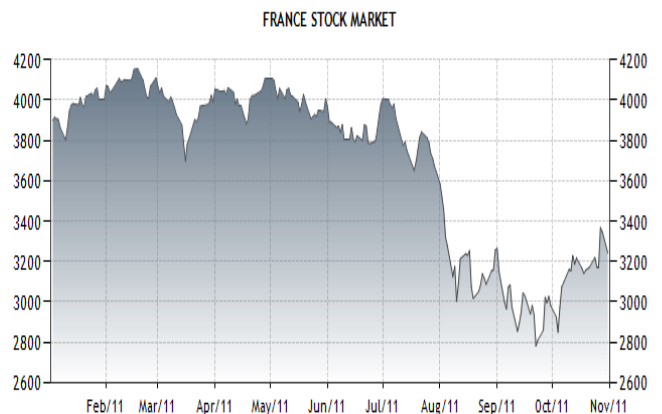


As growth continued being dismal (see figure above right), the French government (which had been violating the letter and the spirit of the Maastricht Treaty since 2003), decided to postpone addressing the malignant cancer that was developing, and on the contrary adopted measures of further profligacy.



That profligacy exacerbated the budget situation and as the two figures below shows, the accumulation of higher deficits could have only deteriorated market conditions.





Financial stocks in France have lost close to 50% of their value since August. Banks have significant problems renewing their loans and refinancing their own bonds that are maturing. The ECB opened its lending facilities to banks which borrowed a record €330 billion the week of November 14.

France's GDP is about €2,500 billion, and its debt stands at about €2,070 billion. France currently pays approximately €80 billion in interest payments and its youth unemployment rate exceeds 20%. With an interest payment moratorium France will reverse to primary budget surplus within the first year, will reduce its debt levels significantly over the course of the next five years and will reap all the other positive effects mentioned in the case of Italy.

Austerity measures not only did not work, but made the situation worse throughout the EU. Given the market exostosis, the estimates made to create primary balances in national budgets are provided below:

	Adjustment period (in years)	Primary balance, start (% GDP)	Primary balance, end (% GDP)	Primary balance adjustment (% GDP)	Adjustment per year	Average real GDP growth in adjustment period (%)
Germany (1975-1989)	15	-4.2	2.7	6.9	0.5	
Netherlands (1990-2000)	11	0.5	5.6	5.1	0.5	
France (1993-2001)	9	-3.1	1.5	4.6	0.5	
Austria (1995-2001)	7	-1.8	3.4	5.2	0.7	
Spain (1982-1989)	8	-6.3	-0.3	6	0.8	
Portugal (1978-1984)	7	-5.2	0.3	5.5	0.8	
Italy (1985-1997)	13	-4	6.6	10.6	0.8	2.1
Belgium (1981-1990)	10	-7.4	4.9	12.3	1.2	2.1
UK (1993-1999)	7	-4.9	3.8	8.7	1.2	3.2
Ireland (1981-1989)	9	-6.3	5.1	11.4	1.3	2.3
Italy (1975-1977)	3	-7.9	-3.9	4	1.3	
Greece (1989-1994)	6	-5.5	4.2	9.7	1.6	1.4
Finland (1993-2000)	8	-3.9	9.7	13.6	1.7	3.8
Sweden (1993-1998)	6	-5.5	5.8	11.3	1.9	2.4
Denmark (1982-1986)	5	-2.6	11.6	14.2	2.8	3.9
Average	8.3	-4.5	4.1	8.6	1.2	
Greece (2010-2014) /1	5	-7.9	4.8	12.7	2.5	-0.3

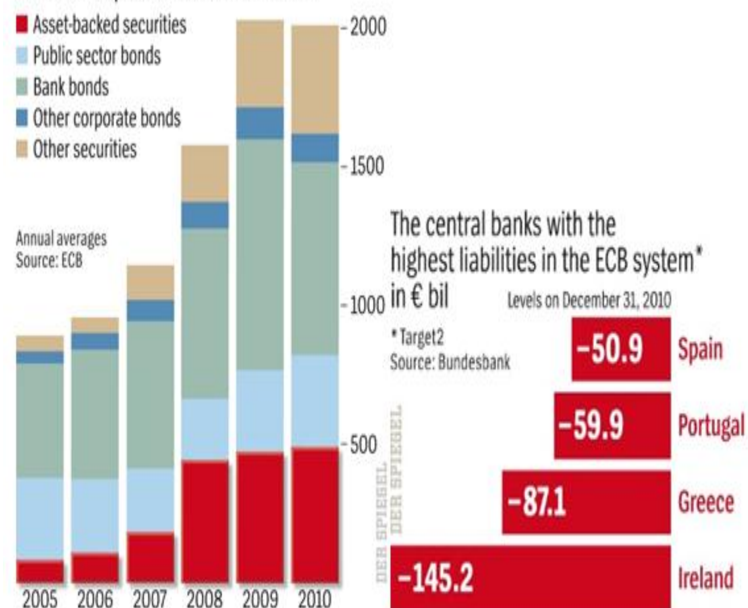
Source: Barclays Capital

As the table above shows, the average time required to adjust the fiscal balances exceeds eight years and demands significant sacrifices which may not be politically and socially viable.

In addition, when we take into account all the unfunded liabilities (pensions, healthcare, etc.) the situation within a few years becomes way more desperate. The need to return to primary surpluses the soonest possible becomes a necessary condition for any plan that desires to avoid catastrophe and chaos. The IMF states: "*[The primary balance] can be said to provide an indicator of current fiscal effort, since interest payments are predetermined by the size of previous deficits. For countries with a large outstanding public debt relative to GDP, achieving a primary surplus is normally viewed as important, being usually necessary (though not sufficient) for a reduction in the debt/GDP ratio.*"

Our proposal almost guarantees the achievement of primary surpluses within a year and thus sets the economies on a growth trajectory. The markets will rejoice and won't treat that as a credit event, given that there will be no haircuts and a viable bottom will be identified.

Moreover, if something significant - such as an interest moratorium – does not take place very soon, the balance sheet of the ECB might be at risk, given the amounts of guarantees that have been provided as the following figures shows.



There are risks that unless a proposal similar to the one presented in this essay is enacted, the risks within the ECB's balance sheet will unleash a domino effect that will degrade asset-backed securities, corporate bonds, bank bonds, other sovereign debt, and will shake the foundations of the EU banking system. Our proposal of an interest moratorium is far more feasible than other proposals put forward including that of Euro bonds, because it is immediately applicable, does not endanger higher financing costs for anyone and guarantees full payment of principal to the bondholders, thus institutional and private bondholders do not need to write down losses. This could truly be a soft landing.

Given that banks hold their bonds in "hold to maturity accounts" our proposal retains book value, protecting the balance sheets of banks. Otherwise a mark-to-market procedure will be enforced on banks' balance sheets, devastating their books. The proposal guarantees credit ratings for the top holders and provides ample opportunities for improvements to all the other countries. Furthermore, this proposal protects national sovereignty while other proposals put this in jeopardy. This proposal, once and for all, rules out any kind of default and restructuring.

Finally, if in a strategic fashion current reforms continue, free trade-zones are installed, public assets are privatized and dormant assets are revitalized (as happened in Brazil during the early 2000s) the EU could start seeing the light at the end of the tunnel.

Needless to say that with a global interest payment moratorium, the less fortunate countries will also benefit substantially and the global economy will set itself on a course of debt sustainability, growth, stability, lower deficits and higher employment levels, while it also tries to heal the wounds of social and economic inequalities.

Ode to a Seisachtheia of interest payments!

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