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Strong action necessary to douse Greek flames

From Prof Jean Pisani-Ferry and others.

Sir, Strong and co-operative policy action inspired by clear views about the future shape of the euro area is needed now. As French and German economists, we agree on a number of steps that should be taken now.

The very limited Greek debt reduction proposed on July 21 is inadequate. Bondholders should take a cut of about half on their outstanding Greek government bond portfolios.

To ensure stability, this debt restructuring process could be combined with an offer to exchange Greek sovereign bonds for securities issued by the European financial stability facility.

Every Greek bond with a nominal value of €100 could be exchanged for an EFSF bond worth €50 (say). The outstanding volume of Greek debt would consequently be transferred to the EFSF's portfolio.

Under this plan the European Central Bank would have the option of swapping its holdings of Greek bonds at their purchase price for EFSF bonds.

Banks that have invested heavily in Greek sovereign bonds would require special support. This applies first and foremost to Greek banks. The EFSF could be mandated to contribute the necessary capital injection, in addition to funds earmarked for recapitalising Greek banks included in the International Monetary Fund/European Union programme.

Banks in most other countries could be recapitalised by their own sovereign, though EFSF money could also be provided if required. This action should be expedited, even if it is politically unpopular.

This move might trigger contagion to other vulnerable euro-area countries. This would not pose a big problem for Ireland and Portugal, as they will be fully funded by the EFSF/IMF for a number of years. Spain and Italy should step up their growth-promoting structural reforms and apply, if necessary, for a contingent credit line from the IMF.

Once solvency problems are dealt with, one is still left with the risk of potential self-fulfilling liquidity crises.

Ultimately, this risk can be banished only by resolute and common action by the governments of the eurozone, the EFSF and the ECB.

Such steps would cause short-term pain but would lead to a viable trajectory for the Greek economy, recapitalised banks in the euro area and improved confidence.

Improving euro area institutions and governance, restoring competitiveness and growth are indispensable items on the agenda. But, let us just all agree now on putting out the fire as quickly as we can.

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