Are the debt deals coming out of this latest summit of EU leaders sufficient enough to address the region's economic woes?

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The Politics of the Euro-Zone Debt Deal

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Next Act—The Plan Is Put to Test

By STEPHEN FIDLER

BRUSSELS—Will it work?

The deal euro-zone leaders hammered out in the early hours of Thursday sparked a world-wide stock rally. But the market moves belied widespread caution about the accord among economists and analysts—and even some of the decision-makers in the debt crisis.

Many pointed out the summit announcements lacked critical details that must be hashed out in the weeks and months ahead, and then put into effect. "The implementation challenge is as high, if not higher, than the design challenge," Mohamed El-Erian, chief executive of Pimco, which runs the world’s largest bond fund, warned in an interview.

Others were pessimistic on the fundamentals, arguing that neither the deal to cut Greece’s debt by 50% nor the plan to boost the firepower of the euro zone’s bailout fund, known as the European Financial Stability Facility, or EFSF, would be enough to quell Europe’s torrid debt crisis.

Only the European Central Bank’s continued support of the region’s bond markets can prevent an eventual further downward lurch in confidence, many argued. Some analysts saw the deal’s lack of measures to boost economic growth as an Achilles’ heel.

Indeed, the markets most critical to the euro zone’s financial health reacted coolly. Interest rates on sovereign bonds for Italy and Spain—the two big economies most at risk from being sucked deeper into the crisis—fell modestly but were still higher than is comfortable for cash-strapped governments: Yields on 10-year Italian bonds were around 5.7% and those on Spanish bonds about 5.3%.

That may signal investor skepticism about the leaders’ plans to deploy financial engineering with bailout funds in an effort to lure back bond investors and thereby lower the borrowing costs of Spain and Italy.

Euro-zone governments hope to do this in two ways—each designed to attract a different class of investor.

In the first, Italy and Spain use EFSF finance in effect to insure a proportion—say 20%—of their new government bond issues in case of default. Such guarantees, tradable separately from the bonds, are aimed at providing comfort to traditional bond investors who have been fearful they may not be repaid.

But it’s not clear the guarantees will do the trick. In the first place, sovereign bond markets generally either have no defaults or large defaults in which investors take sizable losses. Small defaults hardly ever happen—so investors may not be comforted by a modest insurance policy.
Success also depends on whether investors believe the guarantees will act as advertised. If they pay out in the event of a default, and then the bailout fund chases after the defaulting government for the money it has just lost to bondholders, the bondholders won’t be better off. They’ll just be fighting with the EFSF over the remaining limited funds available from the defaulting government.

The fact is, governments have no idea whether investors will bite on the insurance plan. They are now likely to embark on exercises to gauge what percentage of insurance on bonds would be both enticing to investors and cost-effective for the governments.

In the second model, special-purpose vehicles seeded with “first-loss capital” from the bailout fund are aimed at enticing sovereign-wealth funds and other investors to buy euro-zone government bonds.

Prospects for this model are highly uncertain: Some analysts argue the key to success here is for European governments to spend a lot of political capital persuading potential investors, such as China, to come on board.

The plan would stand a greater chance of success, they say, if the International Monetary Fund could be persuaded to give its imprimatur to the vehicles and monitor recipients’ economies. The IMF played a similar role in the past when it helped create funds aimed at recycling surpluses from oil producers to hard-hit oil consumers after the oil-price hikes of the 1970s.

Some of the investors targeted in this plan may have big-picture strategic reasons to sign up: Perhaps, for example, they want to avoid a collapse of the euro-zone to preserve an alternative reserve currency to the dollar. If so, they might even be willing to invest at lower interest rates than commercial investors. Whether they will is, at the moment, guesswork.

Another major leg of the agreement is a proposal to halve the value of Greek government bonds in private hands—some €210 billion of Greece’s €350 billion total government debt. European Union officials said they hoped the deal would slash €100 billion from the debt burden—which would lower Greece’s debt to a still-lofty 120% of gross domestic product in 2020.

Jens Weidmann, head of Germany’s Bundesbank and a member of the European Central Bank’s governing council, Thursday warned that writing off some of Greece’s debts may ease pressure on Athens to continue with tough fiscal austerity measures. "There can’t be any impression that the haircut or public aid from partner countries is a comfortable way out of self-inflicted problems," he said.

From the perspective of reducing Greece’s debt, it’s a substantial improvement over the deal euro-zone leaders agreed for Greece in July, and later tore up, analysts said. That would have left Greece’s debt in 2020 at 163% of GDP.

But some noted that Institute of International Finance, negotiating on behalf of the private sector, had committed only to "work...to develop a concrete voluntary agreement" on Greek debt. "An invitation to agree to a haircut is not the same as a haircut," said Sony Kapoor, managing director of economic and financial think tank Re-Define.

What percentage of bondholders participate is critical: If a high proportion refuse, the deal won’t achieve the advertised debt reduction. IIF managing director Charles Dallara said in an interview Thursday he expected participation rates to be “very, very high.”

The deal, he said, would likely be a “simple straight voluntary exchange,” far less complex than the menu of options offered under the proposal agreed in July.

However, the latest deal has a wrinkle: The new bonds with lower face value that bondholders will receive in
exchange for their old bonds will be issued under English law, says Mr. Dallara—not Greek law, which governs the old bonds. That will make the task of any future debt restructuring—which analysts say cannot be ruled out if Greece’s economy continues to shrink—so much more difficult.

—William Horobin contributed to this article.