Solving the Euro Area Debt Crisis
What will work and what won‘t

Juergen von Hagen

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Background: Fiscal Policy Framework in the Euro Area

- Principles of fiscal policy:
  - Sound fiscal policies (necessary to ensure the functioning of the euro)
  - A matter of common concern (possible to improve on national policies)
- EU Coordination:
  - Broad Economic Policy Guidelines (confidential and public assessments and recommendation)
  - Mutual Surveillance (checking the consistency of national fiscal policies)
  - Euro-Group for coordination among euro-member states

Background: Fiscal Policy Framework in the Euro Area

- Ensuring sound public finances
  - Excessive Deficit Procedure (Art. 126)
  - No-bailout clause (Art. 125)
  - No financing of public deficits by the ECB (Art. 123)
  - Stability and Growth Pact (Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02; Declaration on Art. 126 of the Treaty on the Functioning of the EU)

Background: Sound public finances

- „Sustainability“ of public finances
- The intertemporal budget constraint:
  - A: *in the long run, the discounted sum of a government’s expenditures cannot exceed the discounted sum of its revenues*. Given expected streams of future expenditures and tax revenues, seignorage can close any gap between the two. If closing the gap requires printing more money, inflation will be the consequence. Is “independence” enough to assure that the ECB can resist political pressures?
  - B: Fiscal theory of the price level.

Background: Sound public finances

- The intertemporal budget constraint:
  - B: *The government's total nominal obligations (money and bonds) outstanding divided by the price level must be equal to the expected present value of all future real government budget surpluses.*

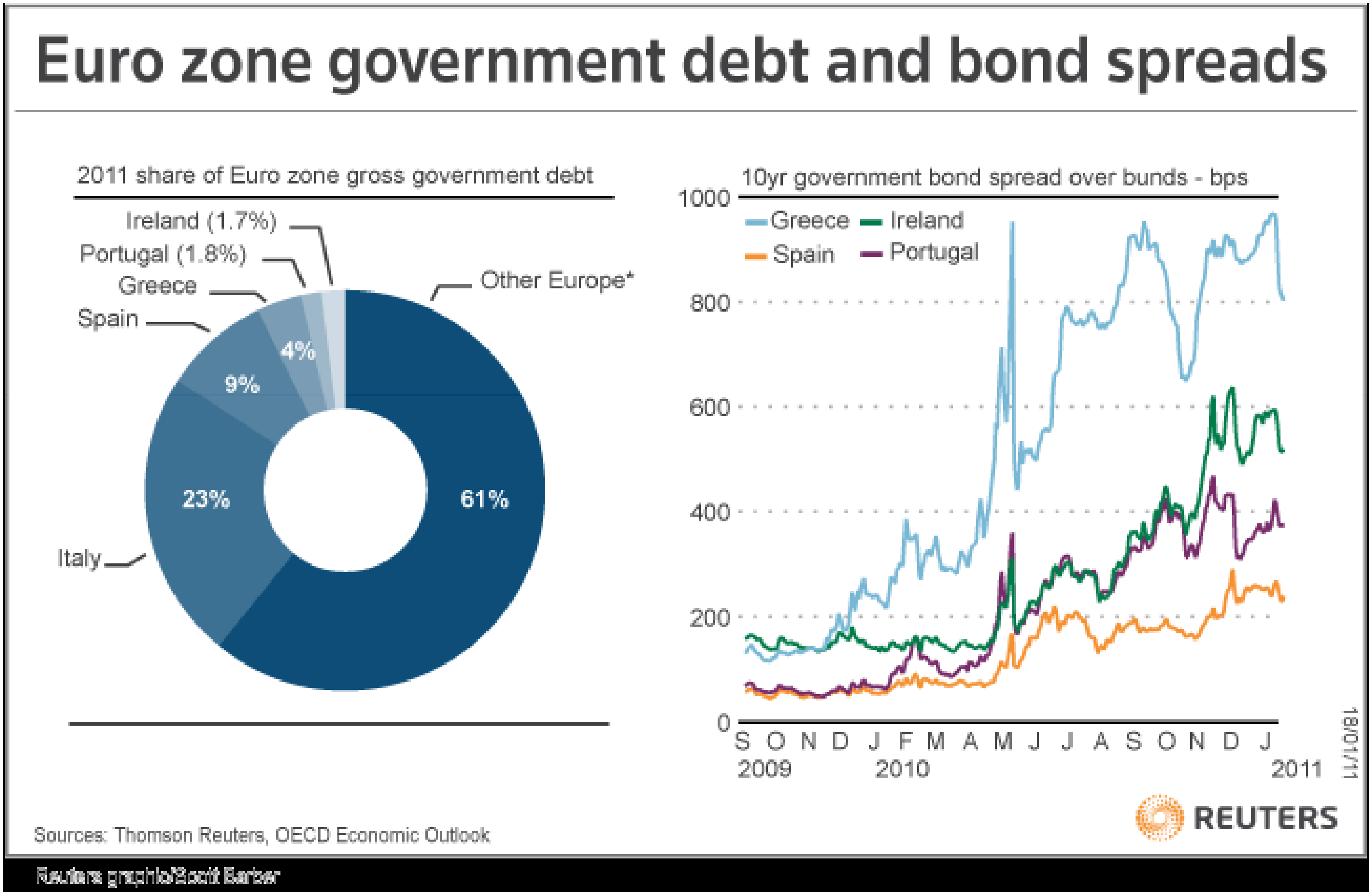
    Even an independent central bank cannot avoid inflation resulting from unsustainable levels of public debt
  - C: *In a monetary union, the constraint must hold only at the union level. An individual government can relax its policy with no consequences for the others, if the aggregate constraint holds. In the monetary union, monetary stability can be preserved by bailouts.*
  - D: The IBC has only weak implications for the conduct of fiscal policy in the short run. A tough enforcement mechanism will not be credible.

Background: Fiscal Union by Statistics

- The EDP:
  - Numerical criteria as triggers for critical assessment
  - Sound judgment by an independent judge (the Commission)
  - Commission proposes, Council decides.
- The SGP:
  - Stronger surveillance based on annual stability reports
  - More restrictive objectives „Close to balance or above“
  - More automaticity in the procedure
  - Less power to the Commission, more power to the Council
- SGP Reform:
  - Triggered by the non-compliance of the large states
  - Introduced more „flexibility“ by differentiating budgetary objectives
  - More discretion for the Council

Lessons from the European Sovereign Debt Crisis

- Economic Issues:
  - The euro has reduced the borrowing capacity of euro-area governments, because euro debt is both „domestic“ and „external“. Markets have only realized this during the crisis (spreads).
  - Due to financial market integration, a large part of the debt issued by individual governments is typically held by banks in other euro-area countries. A sovereign debt crisis can, therefore, become a banking crisis.
  - Government debt is the principal type of collateral used in the ECB‘s monetary policy operations. A sovereign debt crisis creates liquidity problems making the ECB‘s operations dysfunctional.



Euro zone government debt and bond spreads
2011 share of Euro zone gross government debt
Ireland (1.7%)
Portugal (1.8%)
Greece
Spain
Other Europe*
4%
9%
23%
61%
Italy
10yr government bond spread over bunds - bps
Greece
Ireland
Spain
Portugal
1000
800
600
400
200
0
S O N D J F M A M J J A S O N D J
2009
2010
2011
18/01/11
REUTERS
Sources: Thomson Reuters, OECD Economic Outlook
Reuters graphic/Scott Barber

Lessons from the European Sovereign Debt Crisis

- Institutional issues
  - There is a tension between European solidarity and the sovereignty of the member states, which has left markets guessing and created excessive volatility.
  - A „no bailout clause“ without a game plan for the case of default is not time consistent, hence not credible.
  - The ECB has developed a vital interest in keeping governments afloat, thus compromizing its independence.

Lessons from the European Sovereign Debt Crisis

	Greece	Ireland	Portugal	Spain
Domestic banks' claims on sovereign	56	5	14	201
EU banks' claims on sovereign	62	17	40	94
ECB claims on sovereign	40	20	20	
Official EU claims on sovereign	20			
EU banks' claims on domestic banks	9	112	51	217

Billions of Euros; Source: BREUGEL

Lessons from the European Sovereign Debt Crisis

- A lesson still to be acknowledged: Unsustainable debt is unsustainable
- Temporary solutions will not work

Lessons from the European Sovereign Debt Crisis

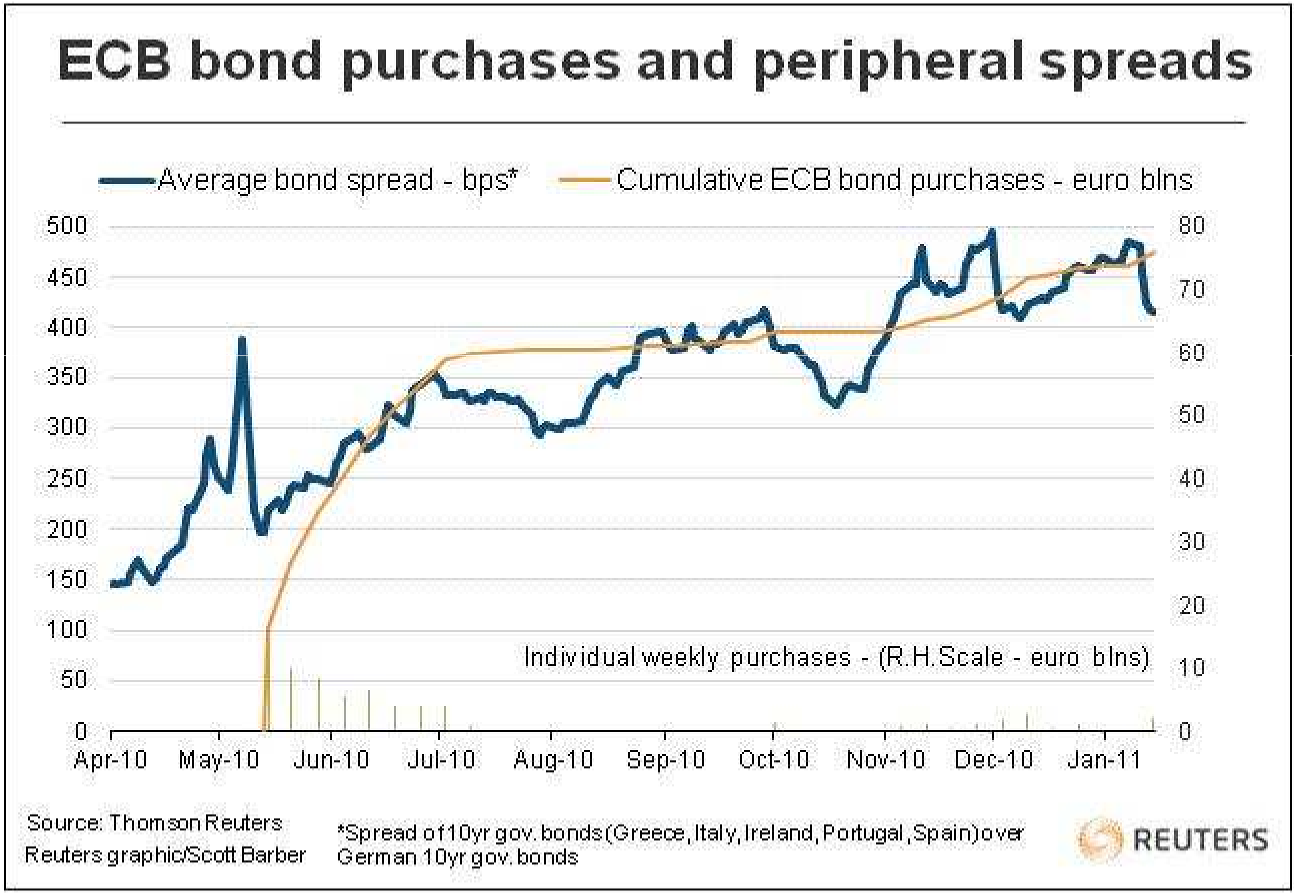
Primary balance adjustment needed to stabilize Debt/GDP ratio at projected level

	ES	PT	IE	GR
Debt ratio	75%	95%	115%	155%
r-g = 2%	1.5	1.9	2.3	3.0
r-g = 6%	4.4	5.6	6.8	9.1
2012 primare balance proj.	-2.7	-1.1	-4.8	-0.3
Gap (6%)	7.1	6.7	11.6	9.4
	r-g projections			
2011	4.7	7.0	8.1	14.5
2012	3.7	5.2	7.1	10.2

Initial solutions

- European Financial Stability Fund
  - Temporary financing facility (expires 2013)
  - EUR BN 450 (MS) + 50 (Commission) + 250 (IMF)
  - But less than 2/3 of that effectively
- ECB bond purchasing program (EUR BN 76.5)

Initial Solutions



Solutions

- More government by statistics
  - Favored by the Commission
  - Closer budgetary surveillance (European semester)
  - More ambitious fiscal targets
  - Tougher and more automatic sanctions

Will not work because of adverse incentives and lack of enforcement.

Solutions

- Euro Bonds
  - Favored by highly indebted countries and Luxembourg
  - Euro bonds would be guaranteed by all euro area member states.
  - Advantage: low interest rate for highly indebted countries
  - Disadvantages:
    - market signals and discipline suppressed
    - With low interest rates, the same countries would borrow more
    - Uncontrolled common pool problem

Solutions

- A Euro bailout fund
  - Favored by the ECB
  - As a lender of last resort for sovereigns, the Fund would buy or guarantee the debt of highly indebted countries automatically in a crisis
  - Bailouts not linked to expulsion from monetary union
  - Strict conditionalities

  An invitation for excessive borrowing!

A Framework for Sovereign Debt Default

- Rules for orderly restructuring of excessive sovereign debt
  - Provide a game plan for governments and financial institutions in the case of debt crisis (time consistency problem)
  - Acknowledge that unsustainable debt is unsustainable
  - Involvement of the private sector in the solution
  - Holding governments responsible for their policies
  - Possibility to provide fresh money conditional on restructuring.

Issues to be addressed by a debt resolution mechanism

- Balancing the interests between borrowers and lenders (and foreign tax payers).
  - Avoid incentives for frivolous default
  - Maintain viable government functions
  - Respect principles of democracy
  - Debt restructuring should apply to all creditors and debt instruments
  - Main goal must be to restore the sustainability of public finances
- Coordination among bondholders
  - Ex ante: Avoid creditor grab races
  - Ex post: Protection against rogue creditors through supermajority rules
- Insolvency vs. Illiquidity
  - Provision of fresh credit after solvency has been restored

The European Crisis Resolution Mechanism

- The European Court of Default
- The Economic Body
- The Financial Body

The ECRM

- The European Court of Default
  - Can open a debt-restructuring procedure at the request of a euro-area sovereign borrower and upon approval by the „economic body“
  - Declares a standstill on all claims on the borrower
  - Rules on disputes between the borrower and its creditors
  - Declares the final agreement between the borrower and the creditors binding for all creditors.
  - Future bond contracts declare this court as having sole jurisdiction.

The ECRM

- The Economic Body
  - Could be a unit within the Commission
  - IMF involvement is possible but not necessary
  - Determines whether the borrower‘s public finances are truly unsustainable
  - Organizes the negotiations between the borrower and the lenders
    - Judges the accuracy of the borrower‘s financial and economic statements
    - Evaluates the implications of restructuring proposals

The ECRM

- The Financial Body
  - Could be the permanent EFSF
  - Negotiates fresh loans AFTER an agreement among the borrower and the creditors has been reached.

Financial Market Implications

- Acknowledging the possibility of default
  - requires to revoke the assumption that sovereign debt is risk free in banking regulation
  - strengthens the incentive for private lenders to monitor the fiscal performance of euro-area sovereigns
  - will lead to lasting and possibliy large interest rate spreads among euro-area borrowers

Why not CACs?

- Collective Action Clauses have become common in bonds issued by emerging market and developing countries.
- Provide a remedy against rogue creditors.
- CACs disregard the problem of creditor grab races.
- CACs disregard the financial stability issue. Pure „market solutions“ are impossible, since the governments would be involved anyway.
- They invite discrimination between different bond issues of the same borrower.
- In the euro-area case, actual bond contracts often do not exist, as the debt is created by other legal instruments.