A New Start for the Eurozone
Dealing with Public Debt

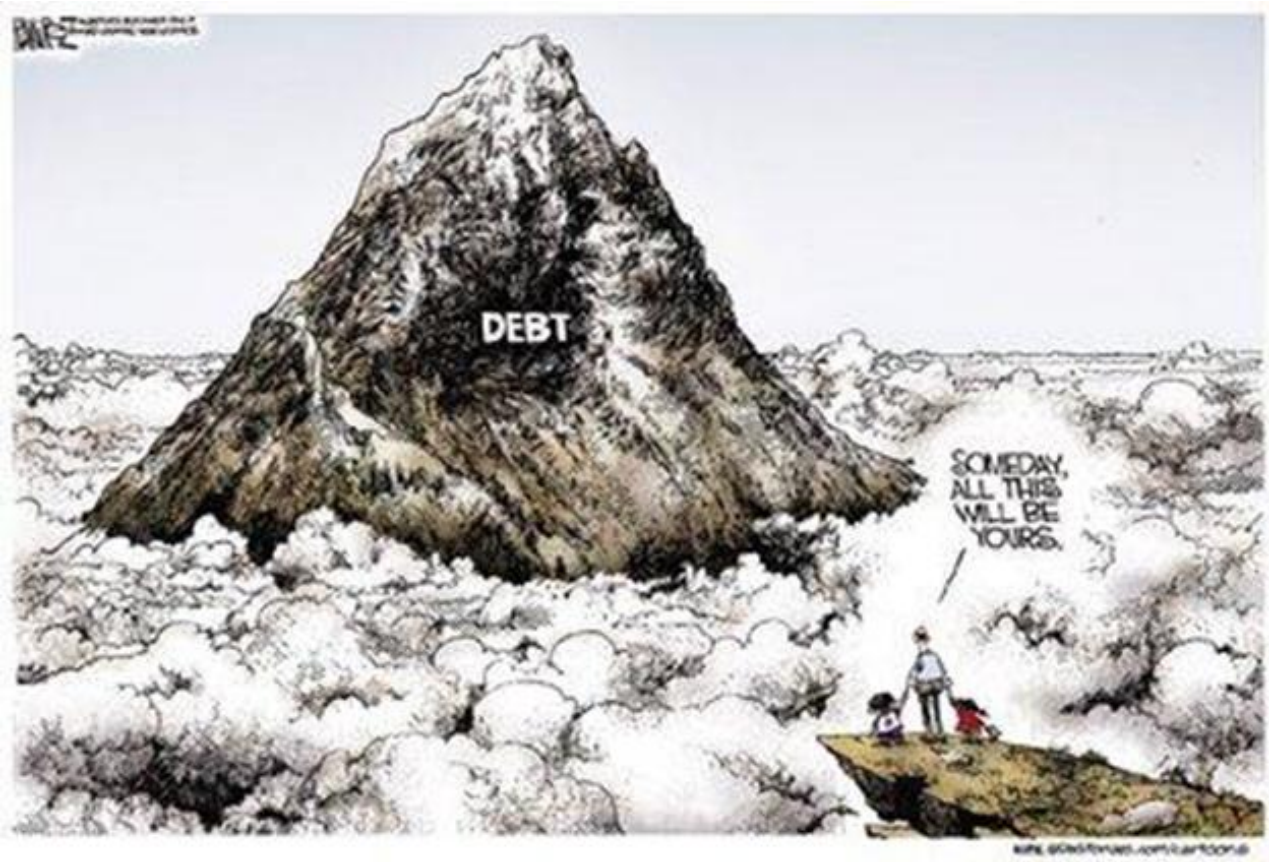
Giancarlo Corsetti, Lars Feld, Philip Lane, Lucrezia Reichlin,
Helene Rey, Dimitri Vayanos and Beatrice Weder di Mauro *

Presentation by
Giancarlo Corsetti (Cambridge University and CEPR)

OESTERREICHISCHE NATIONALBANK Workshop
Toward a Genuine Economic and Monetary Union
Wien, September 11, 2015

* We are grateful to Jeromin Zettelmeyer, Luis Garicano for their important contributions to earlier drafts.

Not funny



In the eurozone

Debt accumulates fast despite deep fiscal retrenchment.

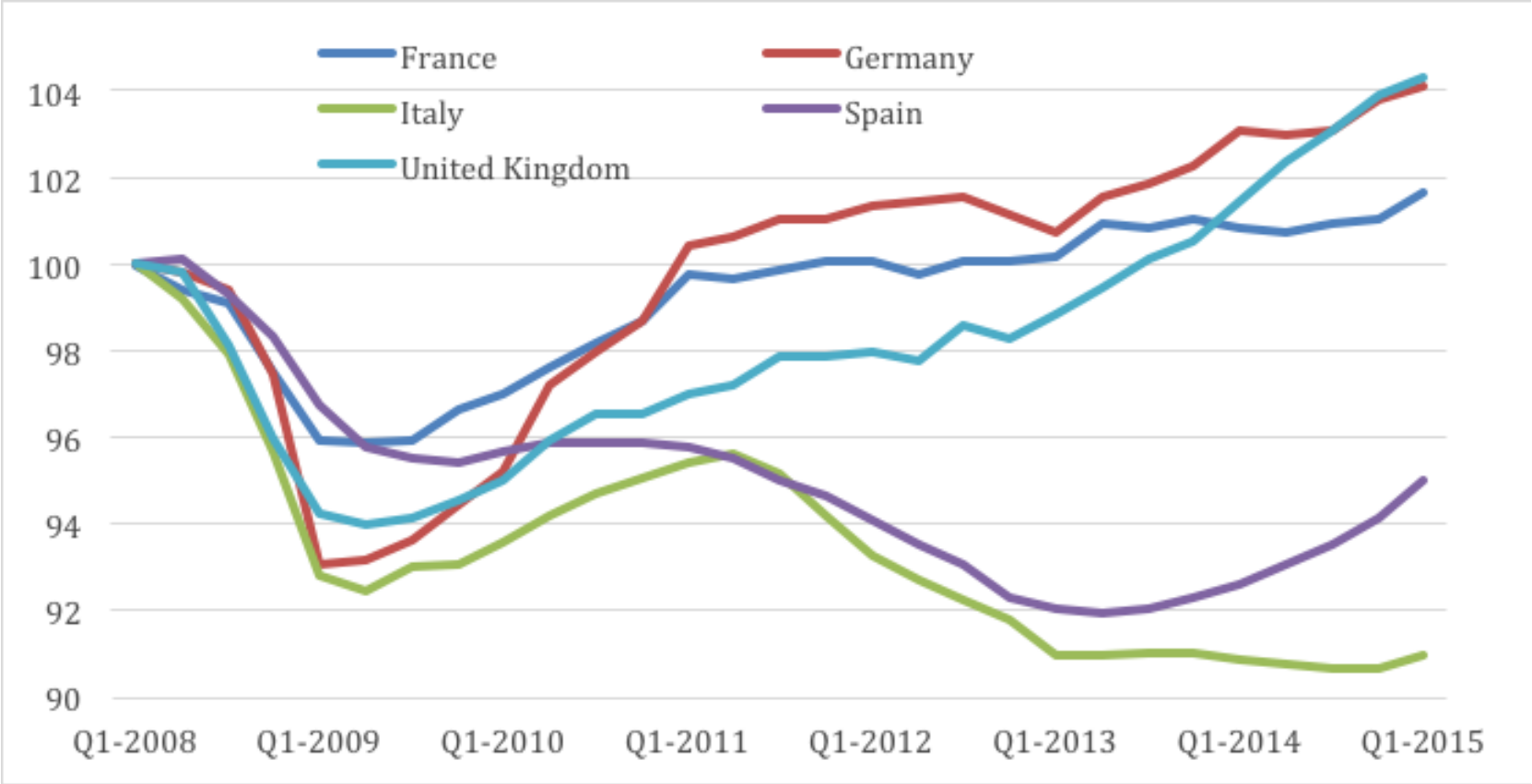
At the outburst of the global crisis, many countries outside the euro were considered high risk because of the size of their financial sector. Membership in the eurozone initially appeared to provide a shield against the crisis.

Over time, reversal of fortune: countries outside the euro managed to put the "risk premium genie" back into the bottle. In the EZ, insufficient institutional development ("incomplete monetary union") let this genie out.

Only in 2012 the ECB was in a position to introduce the OMTs. But the delay substantially worsened the state of the economy.

The perils of an incomplete monetary union

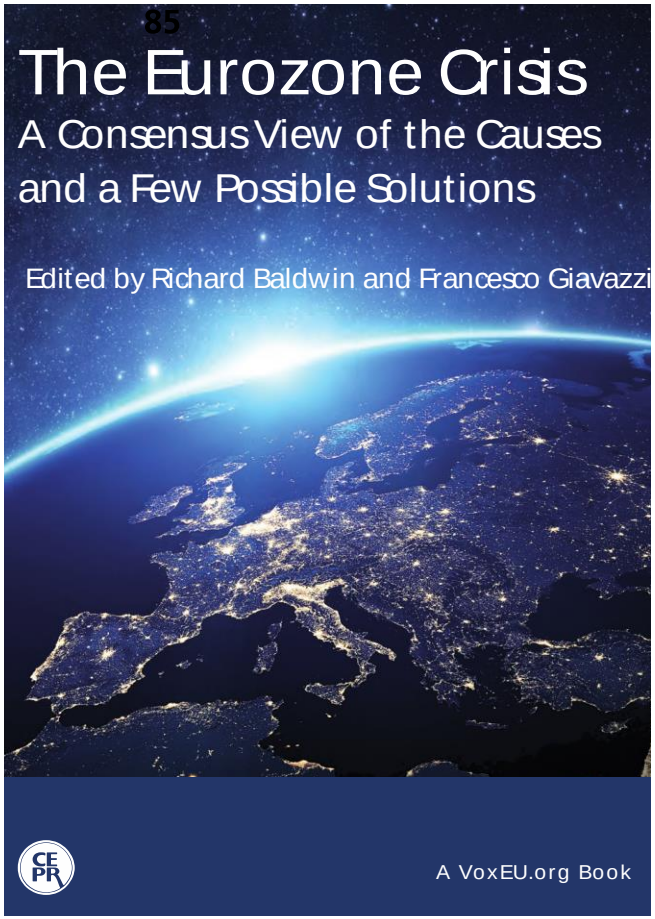
GPD in selected countries, 2008Q1: 100



The perils of an incomplete monetary union

Roots of the Eurozone crisis: Incomplete development and imperfect credibility of institutions
Giancarlo Corsetti

My chapter in the voxeu ebook out this week:



And my Schumpeter lecture: "The mystery of the printing press", EEA August 2015

A New Start for the Eurozone: Dealing with Debt

MONITORING THE EUROZONE 1

The MEZ report in a nutshell

Quick debt reduction and relief paves the way for better fiscal and financial governance.

Coordinated policy

- **decrease the legacy debt *(debt buy-back and relief)***

  vis-à-vis

- **a permanent improvement of the fiscal governance of the euro area (*the new ESM lending regime*)**

- **a structural solution to the diabolic loop and creation of safe asset**

Outline of the presentation

I. Background

II. Eliminating excess (public) debt

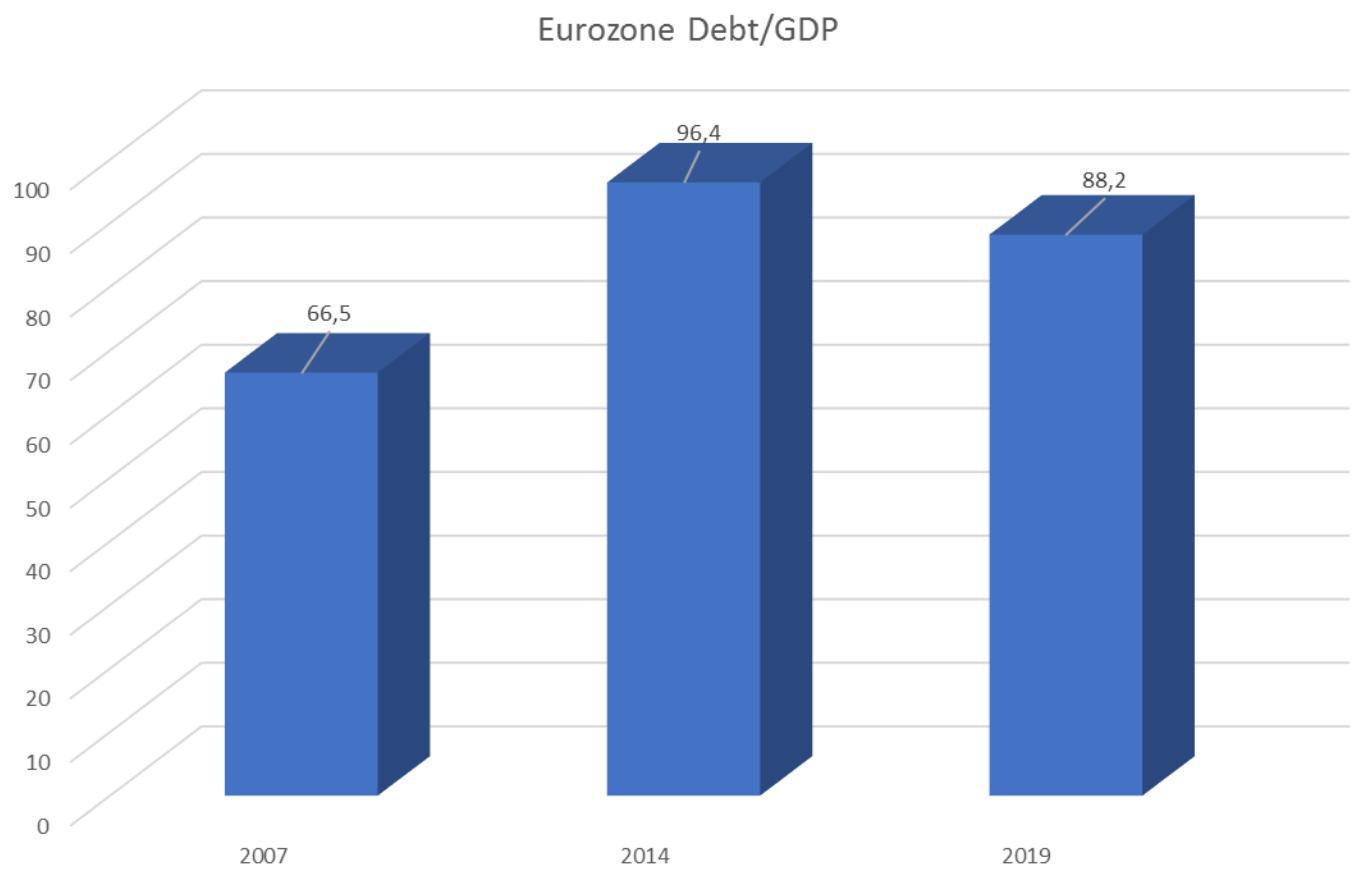
III. Strengthening the lending regime

IV. Reducing home bias and creating a safe asset

V. Conclusion

I. Background: public debt levels remain high

Source: WEO Oct 2014



I. Background: Not such a concern at todays interest rates

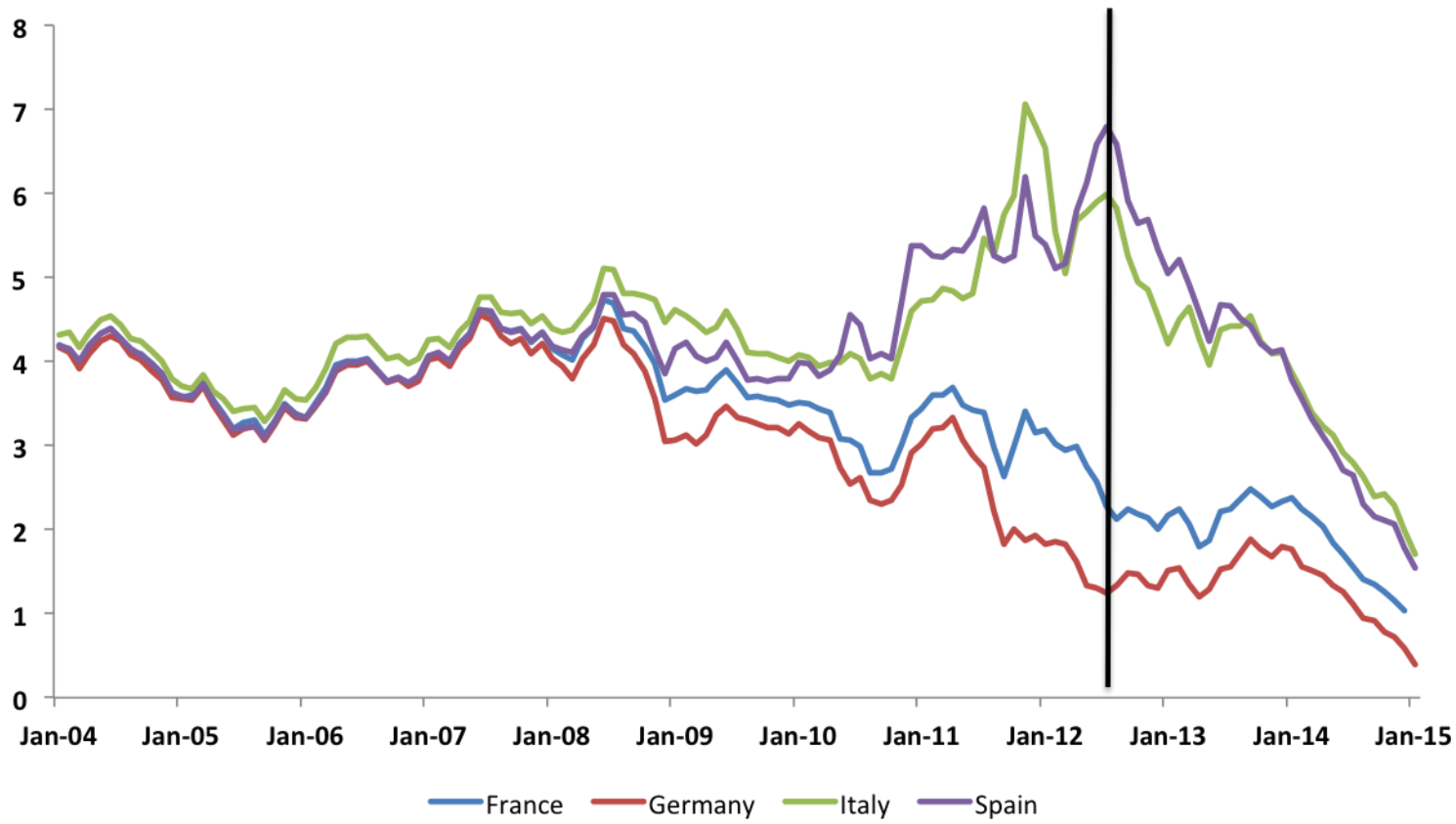


Figure 1. Long-term government bond yields

I. Background: But high debt entails serious risks

- ***Growth problems*** **that works through worries about debt sustainability and unpredictable forms of future fiscal adjustment at the expense of business. This deters investment (debt overhang).**

- ***High externalities*** **of any attempt to restructure on the rest of the monetary union. These externalities make (large) countries "Too Big Too Fail", create incentives to restructure "to little too late" (persistence of excess debt).**

I. Background: But high debt entails serious risks

- ***Sovereigns remain vulnerable*** **to higher interest rates and at of a "risk on" switch of markets. The OMTs have addressed key issues in self-fulfilling creditor runs, but very high level of debt is still a threat and the bank-sovereign diabolic loop still a potential accelerator of fundamental shocks.**

- **The central bank may become overburdened if it has to provide a monetary backstop to government debt in the grey area of illiquidity/insolvency. Concerns about the risks in its balance sheet may increasingly limit its scope for intervention.**

I. What to do? Adjustment

- **Fiscal effort for debt reduction, in a way that does not kill the economy, i.e. stretched out over a long time.**
- **Designate a revenue source for the purpose of buying back debt and pay it into a special fund.**
- **Stability Fund set up at the European level, shielded from the control of individual countries.**
- **Advantages over pursuing similar policy at national level. Fund politically accountable, but not controlled by individual countries. Reneging on contributions politically costly.**

I. What to do? Adjustment

- **The debt reduction could come from a combination of various sources:**
  - **Purely national**
  - **European equalization**
  - **Private sector**
- **Initial, one-time deal: it works if accompanied by reform of the euro area governance so that the "no bail out clause" can be enforced; regimes that eliminates incentives to avoid/postpone defaults under condition of strong fiscal stress.**

I. What to do? Fiscal financial framework

- **Fiscal: eliminate incentives to over-borrow/over-lend (public or private), credible regime that limits official lending and involves the private sector. *(New Lending Regime)***

- **Financial: delink national banks and sovereigns, fundamental sovereign risk pricing *(New financial regime)***

- **How to get there: Need to reduce excess debt rapidly and equitably *(Eliminate Legacy)***

II. Dealing with legacy debt: options

One time operation, bring all countries out of the zone of vulnerability (debt below X% of GDP)

1. **Buy back operation via stability fund (public/public)**
   - **Using only national resources (VAT, wealth transfer tax, seigniorage)**
   - **temporary and limited transfers**

2. **Debt equity swap (public/private)**

II. Buyback : Capitalizing a fraction of a future income stream in a stability fund

- **National governments commit to dedicating part of their respective fiscal revenues for a period of time to retire debt, and set up a common 'stability fund'.**
- **The 'stability fund'**
  - **would buy a large fraction of national debt upfront**
  - **Against bills collateralised by the future fiscal income of the participating countries.**
- **Stability fund bills would be accepted by the ECB as top-quality collateral for refinancing purposes.**

II. Buyback : Considerations

- **Advantages : can be done quickly and effect on growth may materialize without delay; not a threat to the stability of the financial sector**

- **Issues: raising additional taxes; committing future revenues constrains future allocations; ensuring credibility of future payments; design to avoid windfalls**

- **A neutral fiscal operation? It works if it elicits a credible debt reduction, which require larger primary surpluses and politically acceptable transfers; and reduces debt costs.**

II. Dealing with Legacy: Using seigniorage revenue

Own seigniorage revenue not enough to bring all countries out of the zone of vulnerability

- **Note: own seigniorage (with ECB keys) is a revenue of national government.**

II. National Debt Buyback using Seigniorage, (no transfers)

Debt/GDP after buy back of 50 year non-inflationary seigniorage revenue : 800bn euro, distributed with ECB key

Country	ECB keys	Seigniorage € bn	Debt-to-GDP achieved post-buyback	Shortfall to debt at, say, 95% of GDP € bn
Belgium	3.46%	27.6	99%	-18.3
Cyprus	0.19%	1.5	98%	-0.6
Ireland	1.59%	12.7	104%	-16.3
Spain	11.82%	94.6	89%	59.7
Italy	17.84%	142.7	123%	-454.2
Portugal	2.53%	20.2	117%	-39.0
PM:Greece	*2.79%*	*22.3*	*164%*	*-124.2*

Assumptions: revenue over 50 years, real interest rate of 1 or 3 percent, inflation rate 2 percent; real growth rate 1 or 2 percent; output elasticity of currency demand 0.8.

II. Dealing with Legacy: Additional sources

Measures needed in addition to seigniorage:

- Allow for redistribution of seigniorage, i.e. non ECB keys
- Each country defines an additional revenue source to cover shortfall (wealth transfer tax, VAT)
- Debt equity swap
- Fiscal equalization scheme, 1% of GDP increase in VAT revenues, bring forward over the next 50 years, redistribute per capita (Eurosoli)

II. Eurosoli "Citizen Dividend" of 9755 Euro per person

Country	Own Contribution 1% tax (billions)	own contribution + Euro-soli (billions)	Transfers (billions)	Transfers (% of GDP)	Transfer per year for 50 years (% of GDP)
Belgium	131	109	-22	-5.5	-0.11
Germany	945	804	-141	-4.9	-0.10
Estonia	6	13	6.5	33.3	0.67
Ireland	60	45	-15	-8.0	-0.16
Spain	344	447	103	9.7	0.19
France	696	646	-50	-2.3	-0.05
Italy	527	594	67	4.1	0.08
Cyprus	6	8	2.8	16.2	0.32
Latvia	8	20	11.6	47.9	0.96
Luxembourg	15	5	-10	-21.1	-0.42
Malta	3	4	1.6	19.8	0.40
Netherlands	212	165	-47	-7.3	-0.15
Austria	107	83	-24	-7.3	-0.15
Portugal	57	101	45	25.5	0.51
Slovenia	12	20	8	21.5	0.43
Slovakia	25	53	28	37.6	0.75
Finland	66	53	-13	-6.4	-0.13
Pro Memoria Greece	*59*	*108*	*49*	*27.3*	*0.55*

II. Dealing with Legacy: Debt Buy Back + Eurosoli

Country	(BB)Buy back w. national seigniorage bn euro	€Soli bn euro	*Sum= BB+€Sol bn euro*	Debt to GDP
Belgium	27.7	108.9	136.6	72%
Cyprus	1.5	8.4	9.9	50%
Ireland	12.7	45.1	57.8	79%
Spain	94.6	446.7	541.3	47%
Italy	142.7	594.0	736.7	86%
Portugal	20.2	101	121.6	59%
Pro Memoria Greece	*22.3*	*108*	*130.3*	*104%*

- Table 6: Debt/GDP after combined scheme

III. Private sector involvement

III. Present Eurozone regime:

2011 ESM treaty envisaging the possibility of PSI

- **"In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered" (Preamble (12),T/ESM)**

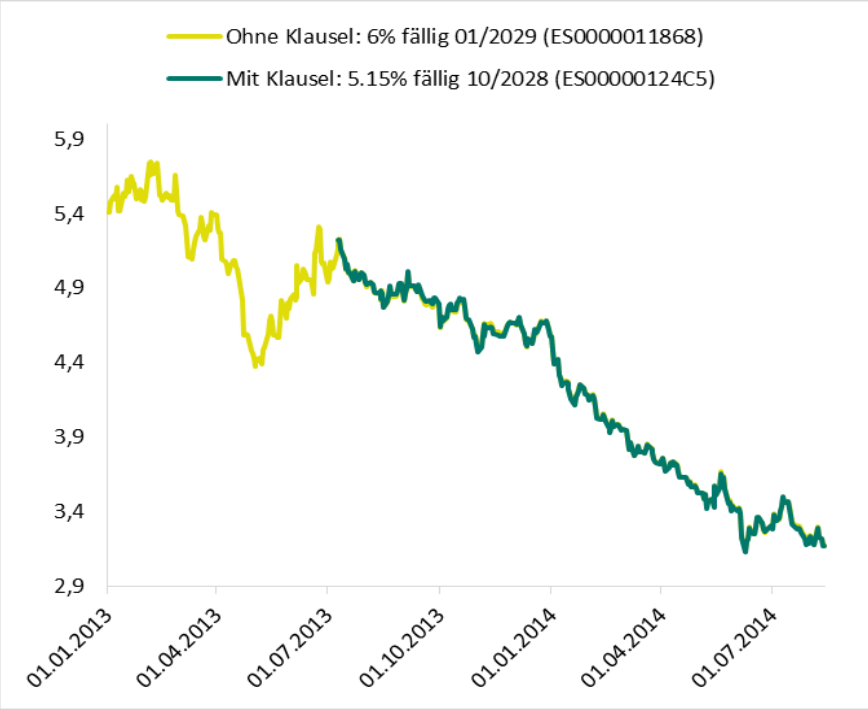
Euro-CACs:

- **Collective action clauses included in all new euro area government bonds as of 1 January 2013 (Art. 12 (3), T/ESM)**

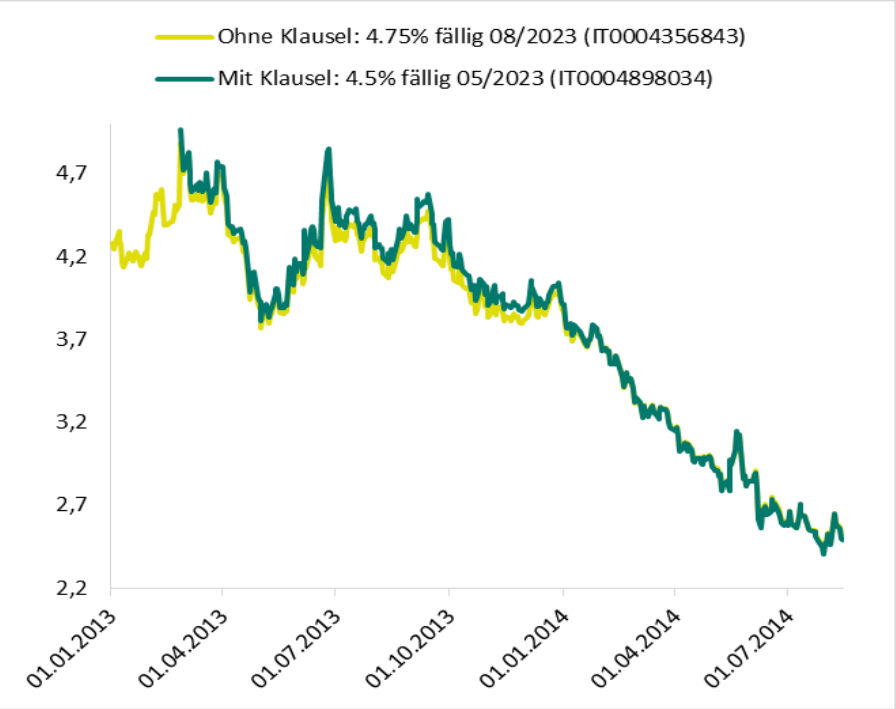
- **"Model CAC" published in March 2012. Includes a (mild) aggregation feature (75% agreement across bonds lowers single-series decision threshold to 66⅔ %)**

III. Not much to see here in terms of "prevention": Need to go further?

Spain



Italy



Source: Steffen and Schumacher 2014, DIW Wochenbericht 39

III. Euro-area specific problem

- **Exceptionally high externalities of disorderly default.**

- **ESM: larger and softer than the IMF may increase incentives to err in favor of additional official lending → diagnose cases of insolvency too little and too late.**

In the absence of a mechanism to condition official lending:

- **EITHER: exceptionally high adjustment burdens (if the official sector does not bail out);**

- **OR: moral hazard (if it does).**

Bottom line: need an additional instrument/institutional arrangment to prevent and deal with solvency crises (see Tirole AER paper).

III. Typical blueprint of lending regime for the ESM

Public debt currently exceeds 60 percent of GDP

Yes

Country is classified as in excess debt

Requires a Excess debt analysis (EDA)
- Baseline scenario
- Stress scenarios
- Vulnerability analysis

Reporting of Risk map

Yes

Public debt currently, projected or under stress exceeds 95 percent of GDP and/ or gross financing needs current, projected or under stress exceed 20 percent of GDP

Country is classified as "at risk of debt distress"

And

Country loses market access

Yes

ESM can provide access on the basis of:

- Debt reduction operation OR
- One time "reprofiling" (extension of maturities without reduction in principal or interest) with an adjustment program sufficient to regain market access

MEZ report not a Deauville proposal – plan is to become binding after excess legacy debt has been eliminated

IV. A safe asset to avoid sovereign market domestic segmentation

The problem: Banks-sovereign loop is the consequence of lack of a safe asset in the euro-area

→ flight to safety takes the form of home bias (see Anil Ari 2015)

Two issues:

1. Perverse adjustment leading to financial segmentation. In the case of sovereign bond market this leads to correlation of risk between sovereign and banks. This is also encouraged by current regulation treating all government bonds as safe and not penalizing domestic concentration

2. No natural target for QE – solution currently envisaged complex and potentially destabilizing

IV. Immunizing the financial system

The ECB announces "diversification rule":

1. for sovereign bonds to attain a risk free weighting, they will have to be held by banks in some given fixed proportions (equal to its share in Eurozone GDP),

2. the 'liquidity coverage ratio' can only be fulfilled through holdings of sovereign bonds in these same fixed proportions,

3. in the conduct of its monetary policy operations, the ECB would buy and sell country bonds in proportionate packages with country debt shares again equal to GDP shares.

IV. Create a safe asset

Consequence: Financial markets will issue synthetic assets in these proportions.

Through tranching

- **Junior tranche, which has positive risk weights and can be restructured easily (helped by diversifcation),**
- **Senior tranche, which banks can hold as risk fee and which the ECB can use for QE.**

Similar as other proposal (ESBies) but no Agency nor new institutions

IV. How to do it?

By (i) changing regulation; (ii) change implementation of QE

1. Change regulation

- **Only the senior tranche of the security so produced could be counted as risk-free for the purposes of the risk weighting and liquidity coverage ratio calculations**

2. Change implementation of QE

- **QE should announce that QE purchases would target such synthetic safe bond**

The private sector buys debt, warehouses and sells assets

V. Conclusion

Several of these proposals have been discussed before individually, incl. by members of this group. What works is their combination in a package ensuring that reforms and actions

- **are strongly complementary,**
- **address both the debt overhang in the short run and incentive problems for the long run,**
- **Contribute to both stability and welfare**

=> implemented jointly.

The politics of it

A quid pro quo: debt reduction and relief in exchange for better fiscal and financial governance.

A one-off coordinated policy

- **decrease the legacy debt *(debt buy-back and relief)***

  vis-à-vis

- **a permanent improvement of the fiscal governance of the euro area (*the new ESM lending regime*)**

- **a structural solution to the diabolic loop and creation of safe asset**