Life in the Eurozone: With or Without Sovereign Default

Franklin Allen
Elena Carletti
Giancarlo Corsetti

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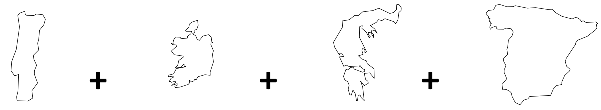
1. The Current Situation: The Euro Crisis: A Crisis of PIGS?

Ramon Marimon



Portugal + Ireland + Greece + Spain = **PIGS**

1992/3
Maastricht Criteria

Control of...

1. Inflation
2. Interest rates
3. Exchange rates
4. Public finances (current deficit and gross national debt)

1999
Eurozone Created

€

1999-2001
PIGS join eurozone

- ECB common interest rate suits biggest member, Germany
- German obsession with **price stability/inflation control**
- Others EZ members 'import' German low interest rates
- Cheap credit/loan boom

2000s
Excessive Borrowing

- Portugal/Greece borrowed from beginning of 2000
- Spain/Ireland later in 00s

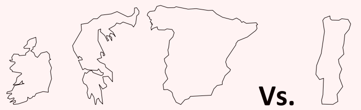
2000s
House Price/Investment Boom

- Investment/Capital floods the PIGS
- Labour Costs ↑
- ...Competitiveness ↓
- ↓ Exports
- To compensate on declining exports → govt borrowing ↑

2 Different Stories

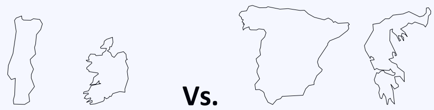
Pre-2007/8 Crisis

Growth



	High			Vs. Low
93-'02	7.7%	2.7%	3.2%	2.7%
03-'07	**5.2%**	**4.4%**	**3.5%**	**1.06%**
07	5.6%	4.3%	3.6%	2.4%
09	-7.6%	-2%	-3.7%	-2.5%

Employment

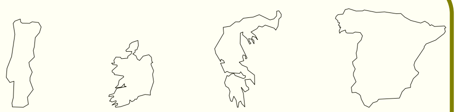


	High		Vs. Low	
00	68.5%	65%	56.5%	56.5%
03	68%	66%	60%	59%
06	68%	**68.5%**	**65%**	61%
09	66%	**61.5%**	**60%**	61%

5 Million Unemployed in **Spain** today

Over 7% drop in **Ireland's** employment rate. More jobs lost **07-09** than created in boom years **00-07**

Balance on Current Account



03	-6.5%	0%	-6.6%	-3.5%
05	-10.4%	-3.5%	-7.4%	-7.4%
08	-12.6%	-5.6%	-14.7%	-9.7%
10	-9.9 %	-0.7%	-10.4 %	-4.5%

Maastricht Criteria

Stability and Growth Pact (SGP)

Allows

-3%

The Iberian Problem

Portugal

- **Not** a property bubble, banking or real estate problem
- Persistent low growth and productivity. Tackling with **cheap credit** borrowing didn't work
- **Brain drain** - skilled colonies bound (Brazil, Angola). Needs human investment, too much focus on austerity?
- Can't devalue in eurozone – increase VAT? (already high at 23%).

Spain

Pros

1. **Better situation** than Portugal – high growth volatility, could spring back fast
2. Big banks **learned** from Latin American experience
3. Strong capacity to **export** and offer quality services

Cons

1. The Spanish dual economy (traditional V. advanced sectors)
2. 'Lost generation' – many long term unemployed and PT
3. Immigration problems
4. Low skilled workforce
5. No regional budget coordination
6. Weak entrepreneurial sector (productivity problems)

2. Life in the Eurozone With or Without Sovereign Default?

Fabio Panetta

Role of the ECB
Changing over time

Phase 1
August 2007-September 2008
(GET THINGS MOVING AGAIN)

- **Money markets impaired**
- Increased demand for liquidity and Long Term funding
- ECB extended long term operations 6 months
- Intra-monthly pattern of refinancing created

Phase 2
September 2008 – December 2009
(RESTORE CONFIDENCE)

- **Global financial crisis** (post-Lehman)
- Banks tightened lending amid recession
- ECB reduced Interest rate to 1%
- Implemented NSMs (non standard measures) – focused on banks, keeping credit and liquidly flowing
- Began to provide additional foreign exchange liquidity

Phase 3
April 2010- Present
(SOVEREIGN SURVIVAL)

- **Sovereign debt crisis with** Sovereign bond market tensions
- One crisis ended (late 2009), another began early 2010.
- NSMs would continue
- Security markets programme (SMP) acquire sovereign bonds in Euro Area countries (limited in scope and temporary)

Increasing severity of situation

Sovereign Debt Crisis
Need for Solution

Main Causes

1. Fiscal profligacy (Out of control spending)
2. Weak banking systems
3. Low competitiveness and productivity

Effects

- Sharp increase in deficits and public debt
- Increase in sovereign spreads
- High financial volatility
- Low liquidity in capital markets

Solutions
(ECB point of view)

(1) **Inflation**
Takes long time to achieve results

(2) **Devaluation**
- Not possible within EMU
- Exiting EMU would have huge costs

(3) **Default**
- Aka 'debt restructuring'
- Arguments for and against

(4) **Reform**
Fiscal Consolidation and Economic Reform

For
- Public support for fiscal measures more likely if country survival on the line)
- Solve immediate debt issue
- Improve growth (by removing interest payment straightjacket)

Against
- After default a TOUGH consolidation would be needed (deficits still exist after)
- Cost of debt/borrowing will rise sharply
- Could affect growth as wealth flees, trade disrupted and capital flows out

Challenging Task Ahead

Bottom Line
- Too risky
- Could cause financial contagion (domino effect) because of close link between sovereign and bank risk in eurozone

Crisis Management Framework (CMF)
Discussions ongoing
- **EFSF** first step (May 2010)
- Need more reforms
- **Reform fatigue** in Portugal and Greece
- Above all – eurozone needs **economic growth**

3. Life in the Eurozone With or Without Sovereign Default? The Current Situation

Helmut Siekmann

Some early facts

1. Crisis is one of **financial institutions,** mainly by big banks
2. **Banks** and **other financial institutions** irresponsible lending
3. Crisis is of **sovereign states** and government with unsustainable debt mountains
4. Crisis affects **ECB** as risks of sovereign debt transferred from market to central banks ('socialisation' of debt)

Crisis of banks which lent too much without charging a risk adjusted price (appropriate interest rate)

Not a € issue

- ECB cannot lend money to the EU
- No stringent link between fiscal problems and currency uses

(TFEU Article 123)

Supervision

Failure of financial markets and economic sciences

+ failure of supervision rules

= crisis!

Lack of Obedience

EU states not adhering to legal norms and contracts

Sovereign Default

Definition

a) Gov entity (public body) is not willing/able to fulfil its financial obligations properly (undefined)

b) Legal procedure to resolve insolvency/illiquidity issues

Insolvency and Law

- Basic society principle of 'pacta sunt servanda' = demand of justice but also economic efficiency
- Orderly distribution of assets of a entity then dissolved at the end of the procedure

Insolvency of Gov Entity

- Gov entities cannot be dissolved
- Legal obligations: All EU-27 *'shall avoid excessive government deficits'*

(TFEU Article 126)

Role of Creditors

- Greek bailout = bailout of French, Spanish and German banks & creditors
- Southern European debt now held by German state banks and institutions of European System of Central Banks (ESCB)

Prevention (Now)

- EU law focused on ***prevention*** not crisis resolution
- **Result**: **Ad hoc *ex-treaty* measures** (EFSM, EFSF)

Prevention (Post-2013)

Fiscal Discipline

Primary Law

Maastricht Criteria in TFEU (Lisbon Treaty)

- **3%** budget deficit **60%** Debt: GDP ratio
- No sanctions – no 'eviction' mechanism
- Avoided fiscal equalisation mechanism

Secondary Law

Stability and Growth Pact (SGP)

- **1997** Original with automatic sanctions
- **2005** Amendments reduced strictness
- **2010** 5 point reform plan

Lack of Common Fiscal Policy?

- No real need in theory
- US doesn't have one nor Germany (until 2009) – US trades grant aid with 'strings attached' for indirect influence
- German lander are not legally forced to avoid 'excessive deficits' in order to fulfil Germanys obligations toward the EU!!

Rules for Aid

*"...by natural disasters or **exceptional occurrences** beyond its control"*

(TFEU Article 122)

No ECB financing of the public sector but 'indirect' purchase of govt bonds via ESCB since summer 2010

EU or members *cannot **'assume the commitments'*** of others

(TFEU Article 125)

Voluntary Bilateral support? Yes! Germany worried about constitutional issues re: their law and Landers

Temporary Support Mechanisms

EFSM (EU) = €60bn
EFSF (€zone) = €440bn
IMF (Credits) = €250bn

Mostly guarantees not direct payments backed by AAA ratings (in only 6 EZ countries)

'where a member state is in difficulties...caused by natural disasters of exceptional occurrences beyond its control.... Council...may grant financial assistance'

(TEFU 122 para 2)

Permanent Support Mechanism

ECB now exposed

Holds a big share of sovereign debt

ESM agreed 17 Dec, 2010

(TFEU Article 136)

A support mechanism set up by member states **outside current Union institutions** could conform with German and EU law

4. Ireland's Sovereign Debt Crisis

Karl Whelan

START

1960s

- Move away from protectionist economic policies
- Universal secondary education
- Large expansion of third level

1970s

- ↑Productivity levels
- Baby boom
- **1973:** EU membership
- Oil crisis late 70s – large fiscal deficits
- **1979**: switch currency link from £Sterl to Deutsch Mark (unstable European Monetary System EMS

1980s

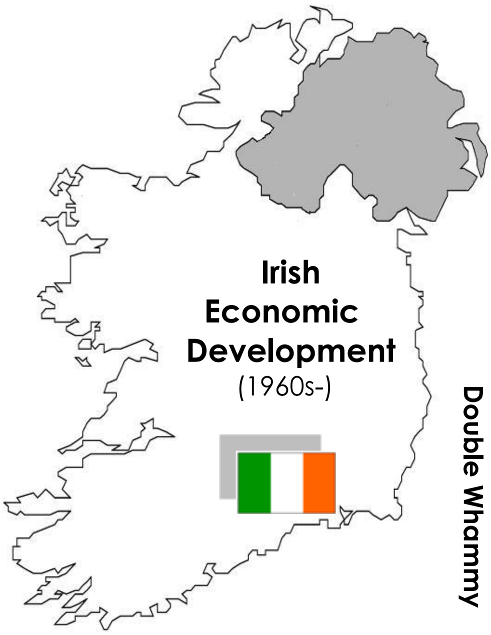
- Debt crisis (1970s fiscal crises)
- **Debt: GDP** >110%
- Interest on debt 10% of GDP
- ↑ Punitive Tax levels
- EMS stabilised
- **1985:** Unemployment peaked >17%
- **1987:** Unity fiscal strategy
- Underemployment- only 30% of population at work. Baby boom peaks
- Primed for growth !

1990s

- Employment friendly demographics
- ↑ Increasing female participation
- Young population
- **Mid 1990s:** economic growth ↑
- **Late 1990s:** ↑ demand for housing
- **Irish economy = Holy Grail economy**
- **1997-Onward:** Taxes increasingly come from stamp/cap gains not income tax

2000s

- Population/Income growth + cheap mortgages via EMU = Increasing housing demand
- House prices skyrocket ↑↑↑
- House completions 93,000 pa in **2006:** (Vs. 19,000 in 1990) – 4x US levels
- **2007:** low debt – well prepared for slowdown?
- Economy built on sand- **housing and construction** (13.3% employment in **2007**, highest in OECD)
- **2007:** Debt: GDP ratio 25%
- **2008:** Housing 'Shuddering halt'
- **2008:** ↓GDP -3.5%, **2009:** ↓-7.6%
- **2011:** House prices fallen 40% and continue



Double Whammy

Late 2000s/Early 2010s

Fiscal Crisis

- **2007/8:** Collapse in construction
- ↑Unemployment, ↑ Social Welfare
- **Late 2008**: Austerity budget €20.8bn, 13% of 2010 GDP (largest budget adjustment in any modern advanced economy)
- **2010** Nominal GDP ↓**20%**

Late 2000s/Early 2010s

Banking Crisis

- **2003** rapid ↑ lending to developers (> exposure)
- Rapid ↑ in mortgage lending
- **2003-07** Irish bank international borrowing ↑ from €15bn to €100bn (worth 50% of Irish GDP)
- Anglo Irish Bank main culprit, expanded at 20% pa, encouraged AIB and BOI to speculate on developers too
- **2008**: **Lehman Collapse** – Irish banks couldn't raise funds on bond markets – need government help or face ruin

Bank Guarantee

September 30th, 2008

- Highly controversial
- Senior civil servants and Merrill Lynch (government advisors) AGAINST it
- **Early 2009**: Bank losses escalate
- Government uses taxpayers money to recapitalise the guaranteed bonds

Banks Need Help: 2010

- National Asset Management Agency (NAMA) set up
- NAMA buys bad loans off bank books at a discount (haircut)
- **Sep 2010**: Final Anglo bill €30bn, covered with 'promissory note'- once off in current deficit to 32%, a world record
- Banks turn to ECB for emergency funding
- Banks run out of collateral to borrow- Irish Central Bank steps in

EU-IMF Bailout

- Cost of government borrowing ↑ as 'bond yields' ↑
- Deauville declaration by Sarkozy and Merkel – new crisis fund EFSF set up
- **Nov 2010** - Irish Gov agreed €62.5bn EU-IMF funding help
- **Involves**: Stress tests of banks to see further funding needs. Happened in **March 2011** (+€24bn)
- Total Gov Spending on banks **€70bn**
- Return to bond markets late 2012?
- Return to 3% deficit by 2014
- Govt now relying on **EXPORT LED** growth

Endgame

European Commission projects Ireland will run out of money mid - 2013 **without return to private bond markets**

- Need to hit austerity targets
- Might tap new **European Stability Mechanism (ESM)**

-NB- Events elsewhere because it might change Europe's attitude to Ireland i.e. **Greece**

5. Quo Vadis, Euroland? European Monetary Union Between Crisis and Reform

Martin Hellwig

Changing ECB

- Modeled on Bundesbank policy of **strict price stability**
- **2011**: Pressure to print € to pay for deficits
- Erosion in this 'stability culture' thanks to EMU (€ safeguards in SGP and Maastricht weak)

Why?

1. EMU depoliticized monetary policy (made it supranational)
2. ↓importance of exchange rate in Europe
3. E. Commission power ↑, encroach on ECB
4. Lack of SGP credibility but EMU needs strong governance requiring a treaty change (which will be v. political)
5. Unnatural tension as national authorities still supervise banks – lack of coordination between central banks (last resort lenders) and govs

ECB Hallmarks

- Depoliticisation
- Professionalisation

So, why is the Current Crisis so Difficult to handle?

- EU needs workable strong governance mechanisms
- Fragile bank balance sheets in Northern Europe = exposure to sovereign debt from Southern Europe and bank debt from Ireland and Spain.
- To solve (A), requires a prevention of (C) (Deauville) - but country has to be insolvent
- No country wants to admit this – proof of it from history (Weimar Germany 1930s, Latin America 1980s) if conditions met – **country can't...**
  - **a)** Collect taxes from elites
  - **b)** Sell state assets
  - **c)** Cut public salaries

3 Crises

(A) Fiscal Crisis
Greece
Portugal

⇄

(B) Banking Crisis
Ireland
Spain

⇄

(C) Latent Banking Crisis
Germany
France

Need to **protect** Northern European banks (aka creditors, bondholders)

Current Discussion: What about EU Solidarity?

In fairness, Germany sacrificed growth and investment to bring in EMU

Different sovereign borrowers (countries) have different fiscal capacities = an *anomaly*

- Without EMU, PIGS **would not have been able** to borrow at low IRs
- **Border solidarity weak**: suspicions and lack of transparency over who is being supported (German bankers Vs. Greece public employee debate)
- This **is NOT a currency crisis** - purchasing power of the euro is not affected (forget what media, politicians are saying)
- **Huge need** for an EU governance system post-2013

Underlying Issues

- Common currency ≠ Common price system. **Prices volatile**
- = EU markets not integrated
- Varying inflation (much higher than US states, Swiss cantons or German lander)
- Exchange rate reflects this but fixed in EMU
- IR should reflect risk – it didn't (common IR via ECB)
- Lack of fiscal discipline by lenders, borrowers and gov

Without EMU Greece/Portugal would have been okay?

Without EMU

No, they wouldn't!

- Couldn't have borrowed in the first place
- May have borrowed in foreign currency
- In crisis, they would have devalued – inflating their debt priced in their home currencies (but tradable exporting industry would be made more competitive)
- **'Original sin'**- inability to borrow freely in ones own currency b/c risks inherent in foreign currency borrowing

Recommendations

New fiscal governance mechanism must be sensitive to countries banking system

- Ireland, Spain – not arisen due to fiscal policies, more from unsound banking practice + TBTF approach by gov
- SGP says Ireland, Spain doing well – never appeared on radar of SGP. Big problem.

Make bank supervisors independent

- Move away from banks seen as source of govt funds (savings)

Strengthen EU supervisory institutions

- Irish case has repercussions
- If costs of bank bail outs are really born by all EU taxpayers then banking supervision should be at supranational level
- Keep banking supervision and MP away (not under same roof – lessons from US experience)
- Reduce moral hazard issues – no ECB bailouts (discipline institutions)

6. Sovereign Debt and Banks: Need for a Fundamental View on the Structure of the Banking Industry

Arnoud W.A. Boot

Current Crisis Lessons

- Fragility of banks and financial sector
- **Now (2011)**: Sovereign Debt Crisis
- Debt Restructuring will hit bank balance sheets (govt help

Current Problems

- No EU burden sharing/crisis procedures re: supervision of banks
- **De Larosiere Report (2008)** aimed at tackling issue of bank supervision
- Still under national control

Dealing with size and complexity

Breaking up banks and living wills

In other industries, the market can decide the optimal size of firms. **Banking is different…**

- Its very complex, difficult to manage
- Huge interconnectivity reduces info breeds idea of 'Too Big To Fail' (TBTF)
- Supervision/Regulation is therefore tricky

Current Reforms: **'Living Will'** each institution must produce detailed recovery and resolution plans. Drive to reorganise to resolve complexity

Best way to do this? Break up into subsidiaries? **New Zealand model**

New Zealand model

- Banking system foreign owned
- Authorities instituted structural requirements to assert control
- Enforced subsidiaries, making them independent, keep risks low
- Model for EU-27?

2 Solutions to change bank organisation

A B

Breaking up Banks?

- Many UK advocates inclu. Mervyn King (BoE Governor), Adair Turner (Chairman of FSA)
- UK Independent (Vickers) Banking Commission shied away from it

Complexity makes supervision very slow. Breaking up best?

2 lessons via financial crisis

1) **Contagion** should be addressed
2) Core commercial banking functions might have to be **safeguarded**

If a break-up increases transparency and reduces complexity, solve these

In Summary

1. Banks very complex
2. Hard for regulators to grasp linkages
3. **NO** well established solutions

Can Separate Legal structures under one corporate roof be effective?

- Unclear but most do i.e. HSBC with 2,000 entities
- Main purpose: not ↓ complexity and ↑ transparency, just to economize on taxes or for regulatory arbitrage
- Still linked in many ways : offices, shared facilities, activities
- Potential conflicts still enormous
- Industry will oppose any action that would limit synergies – they like complexity and hold supervisors hostage

7. Greek Debt – The Endgame Scenarios

Lee C. Buchheit & Mitu Gulati

June-Oct 2010
ECB

- **Protect the €**
- Buys €40-€50bn worth of Greek debt to keep the monetary show (EMU) on the road

Oct 2010
Deauville Declaration

- Sarkozy and Merkel agree to permanent crisis management fund, the **ESM**
- Markets respond by selling off EZ periphery sovereign debt)

Nov 2010
Irish EU-IMF Bailout

€85bn

€45bn EU/€ zone | **€22.5bn** IMF | **€17.5bn** Irish own

May 2010
Greek EU-IMF Bailout

€110bn

€80bn EU/EZ | **€30bn** IMF

2nd Greek Bailout?
Problems

1. **Contagion** (spark crisis)
2. Effect on **banks** (most Greek bonds held by €zone banks)
3. Effect on the **euro** and **EMU**

March-June 2011
ESM Agreed and Greek Crisis Returns

- **March:** European Stability Mechanism Replaces temporary EFSF from 2013
- **June:** Escalating Greek crisis May bailout insufficient
- Default aka 'Debt Restructuring' likely

Scenarios

Pre-2013 Restructuring
Creditors restructure voluntarily?

a) **A Light Dusting** (Softly softly approach)
- Private sector (Northern European commercial banks) – minimise losses –no haircut, but reprofile debt
- Partial guarantee from the official sector-cushion effects on banks
- **Risks:** Delayed bloodletting?
- **Maturity stretching** is expensive & how to assure bondholders?

b) **Full Monty** (forget about voluntary)
- Full restructuring + Burn bondholders to cut debt
- **Risks:** Need bondholders to work alongside – give discount window (by ECB?)
- One extreme (taxpayer cash) to another

Greece Reaches 2013
The 'Official' Scenario

- **2010-2013 austerity plan**
- Eventual return to bond markets (but when?)
- Turnaround in Greek position- budget surpluses and ↓debt
- Private sector monies start flowing again at good rate

By 2013
- Public debt 150-170% of GDP
- 50% of debt owned by EU-ECB-IMF
- Weak social and political consensus
- Will the IMF-EU reduce the conditions if targets missed?
- €110bn clearly wasn't enough – Ireland has fallen since, and Portugal.

Post-2013
What happens to Greek debt?

a) **Official sector** (EU, IMF) **takes charge**
- By 2013 >50% of Greek debt in official sector anyway (good sign to market)
- **Risks**: EU carry the burden alone? Taxpayers money! IMF 'never restructure' policy

b) **Private sector** (creditors) **takes over**
- Option of 'restructuring '
- **Risks:** Even a 33-50% write off might not return Greek creditworthiness
- Any force would destroy Greek credibility

c) **Both take charge**
- Official sector can't be accused of being kind to commercial lenders.
- Commercial lenders would not face a total write off of the value of their claims.

d) **Wardship**
- Greece a ward of EU/IMF forever!
- Official sector credit would end up paying off commercial lenders as what they're owed fall due.
- **Risks:** Politically unpalatable for everyone

History Lessons

Latin American Crisis (1980s)
- Started in Mexico (1982) + spread
- Official sector refused to bailout banks in **similar situation to today**
- US Treasury stepped in
- **Baker** (later Brady) **Plan**

Baker (Brady) Plan (1980s/90s)
(1) IMF stabilisation program
(2) Payments period extended by 18-24mths
(3) interest payment on debt period – kept current values
(4) Banks then HAD to lend debtors new money – added funds on top of their existing exposure

Today (Unlike Baker Plan)
The axe will fall on the official sector NOT the commercial banks

Then: Banks were kept in check and had to eventually **absorb own losses**

8. Rules-Based Restructuring and the Eurozone Crisis

David A. Skeel, Jr.

Current Eurozone Crisis = 'déjà vu all over again' only closer to home

A Lesson from the Great Recession

Summary: Need a credible, specific alternative to bail-outs or the market will expect more and (self fulfilling prophecy) will cause more

- Post-Argentinean default (2002), expectations for a wholesale reappraisal but IMF funding was limited.
- Kept ad hoc system and added a 'collective action' provision via bonds. Still a need for more **rules based, bankruptcy-like solution.**
- No lessons learned – Europe in same place
- Markets didn't believe US gov bail-out of Bear Sterns (March 2008) was the last one. Markets expected Lehman Bros to be bailed out (Sep 2008)

A New Framework: A Model for Sovereign Bankruptcy

Summary: Proposal for a 'First in Time' Priority Payment (Bankruptcy) scheme for creditors

- Bailouts mightn't be enough (very limited)
- **New idea**: Sovereign debtors (countries in trouble) would have their creditors divided in 2 classes
- Voting process for restructuring – country would submit proposal on haircut, a majority of creditors must vote and agree (class by class vote)

Is the Eurozone Different?

Summary: Portugal, Ireland and Greece (PIG) cannot devalue so bankruptcy procedure is a good option and would fit well into the EMU/EU structure

- Bankruptcy style schemes criticised for creating moral hazard for debtors (countries) – default is tempting as In Argentina (2002)
- Would it work for Europe?
- Greece/Ireland depend on eurozone financing
- An EU-scheme would be less intrusive as eurozone already supranationally controls monetary policy
- PIGs are all in EMU, cant devalue – bankruptcy a good alterative

Implications for European Banks

Summary: As European banks will be affected by default/restructuring/bankruptcy, the countries where these banks are situated should take action

- Biggest concern with the bankruptcy scheme or any restructuring = effect on European banks (which hold a high % of sovereign debt from Southern Europe – potential defaulters)
- **More sense:** Countries where these banks are (Germany, UK, Belgium) to decide to intervene in case of destabilisation following a default.

Who Would Oversee the Process?

Summary: Single judge procedure in an EU country other than the countries own (ideally where the creditor banks and a decent amount of debt is based)

- Most proposals see the IMF or international organisation controlling the process
- Author proposes ordinary bankruptcy process/insolvency judges
- Not ideal for eurozone
- Effectiveness of a single judge for this? Lessons from US and Canada over Chrysler and General Motors
- Panel of 3 European judges?

9. The Economic Consequences of the Euro Pact

Edmond Alphadéry

Wrong Assumptions

Countries Can Leave?
- Members cannot simply go back to national currencies if they leave
- As likely to happen as Texas or California leaving the US$
- Enormous damage to country if they leave, need capital controls
- Damaged members forced to leave EU

Eurozone Breakup?
- Likelihood of breakdown small
- Eurozone is not an optimal currency area
- Would only collapse with systemic shock bigger than Lehman Bros
- **Greek default?**

European Focus
Solidarity + **Sustainability**

Lessons from History
- German reparations post WW1 (punishment which lead to the Nazi rise and WW2)
- Keynes 1919 book 'economic consequences of peace'
- *'If Germany is to be milked, she must not first of all be ruined'*
- Point: **Solidarity** needs **sustainability**

New European Framework
- March 25, 2011 – European Council meeting
- Comprehensive framework for permanent (financial) crisis prevention (ESM) post-2013
- If one jeopardising the European financial sector (unsustainable budget deficits etc) – **time for action**

I- Reponses to the €zone Crisis
- Maastricht (EZ birth treaty) **no** detail for crises
- Cost for the non-EU intervention = Banking/Financial sector bankruptcy + EU image hit
- Why not intervene? Moral hazard
- So, EU must intervene closer to bankruptcy (time a factor), expected cost/benefit of non-intervention nullifies

Europe has intervened 4 times

1. **May 2010:** Greece (EFSM) later expanded EFSF
2. **Oct 2010**: Deauville declaration (permanent fund to be set up by 2013) + Collective Action Clauses to mitigate moral hazard. Irish bailout Nov 2010
3. **March 2011**: Euro Council adopts Euro pact – lowers Greek IR to 4.2% (reschedule loans to 2021)
4. **April 2011**: Portugal bailout

II- ESM Implementation (June 2013)
- ESM fund = €500bn (from EU and IMF)
- Will only giving funding after **sustainability analysis**

ESM Funding will help
- No *burning bondholders* (i.e. Northern European banks, main creditors, don't lose)
- Country will get *good/low interest rate*

ESM Funding wont help
- Must *negotiate* on their own with creditors (bondholders)
- Get *agreement* and a *plan* with private sector
- THEN they can get funding

III- Reduce Pressure on June 2013
2 real options in June 2013

a) Screw 'em
- PIGS on unsustainable path
- No ESM funding
- Let them DEFAULT!

b) Help 'em more
- Done with stabilising debt
- Give them ESM loans with conditionality

- a) or b) not ideal options
- **Best option Countries financing themselves via the market again**

Author models predict
(if a country follows…)

1. **ESM borrowing** (PIG ***stabilise*** debt by 2017)
2. **Market borrowing** @10% interest (***Nearly stabilise*** by 2017)

Moral: Portugal, Ireland and Greece need help with overall debt burdens via programmes to reduce debt i.e. privatisation, improved EU loan terms etc

10. Exiting the Euro Crisis
Charles W. Calomiris

Eurozone Problems

Banking **Insolvency**

Fiscal **Unsustainability**

Why the euro won't last

Realities of the eurozone

Over-Indebtedness
- Excessive
- Need to address via default/restructuring
- Inevitable

High Deficits
Post-default/Restructuring
- Hard to fund your deficits
- High deficit country must leave the € to print money

OR

- Get public sector support for deficit borrowing (difficult)

Non-Competitiveness
1. Over valued exchange rates
2. Poor productivity (exports)
3. Rigid labour markets

Solutions
- Protracted recession and austerity
- Leave € and start again

Lost Causes?
Greece, Portugal
- Greek debt and deficits unsustainable
- Austerity plans not enough
- Main problem: Overvalued exchange rate
- Greece needs a transfer (NOT A LOAN) of €200bn+
- **Conclusion:** Leave EZ
- and rejoin later after reforms take place to their fiscal affairs, labour markets and pension systems

Recovery Possible
Ireland, Spain
- Ireland and Spain need to avoid assume full private bank debts (German, British, Danish, Belgian etc) i.e. they need to burn bondholders
- If they can, they'll be sustainable
- More realistic possibility of improvement in these than Greece, Portugal in short/medium term

What Should Happen
Europe does the following:
- Encourage policy adjustments for the PIGS
- Agree to loss sharing arrangements to absorb losses in an orderly way

What Will Happen
Europe does the following
- Builds Chaos
- Engages in Ad hoc and poorly coordinated emergency measures taken in response to bank runs
- Doesn't convince depositors and causes run on Greece

I- The Numbers Say So
- Sovereign default/debt restructuring seems and resulting departure from eurozone inevitable

II- The Theory Says so
- Real exchange rate theory and political economy
- Americans far more pessimistic about the euro, Europeans in denial?

Author in 1999 suggested that eventually…
- At worst: Eurozone would break up
- At best: Need € depreciation to keep it together
- Southern Europe would become fiscally unsustainable, bank losses = bank insolvencies + fiscal pressure on governments via bank bailouts

Consequences of € launch predictable

1) Eurozone not an optimal currency area (OCA)
2) Economic inconsistencies among members
3) Political differences likely to arise

Author in 1999 predicated this scenario

a) Southern Europe has low productivity growth (in tradable goods) = Productivity gap
b) Reinforced by existing labour, human capital and trade issues
c) 1997 East Asian crisis - Harrod-Balassa-Samuelson theory of real exchange rate - *if 2 countries with productivity growth differences in their tradable goods adopt a common currency eventually the slow prod country will have recession (will need price deflation or devalue currency*)
d) East Asian economies buffering declining profits from trade (as competiveness fell) with credit
e) **Choices**: Slow Growth V. Devaluation **OR** fiscal stimulus **OR** facilitate (via easy bank credit) the growth of non-tradables i.e. housing
f) Say ECB forms EMU, lower IR on debt + already low tradables productivity – more buffering via fiscal binge!

PIGs (and Italy) all did this

III- History Says so
- **1862 US** - departure from the gold standard (to fund civil war) meaning dollar backed by 'Greenback' not gold or silver
- **1933 US** - Gov banned gold clauses in private debt (not just public debt) contracts – protect those in trouble, could survive double blow of weak economy and depreciated dollar
- **2002** Argentina - Left dollar standard and redenominated $ denominated and indexed contracts into the newly depreciated peso

11. Life With and Without Sovereign Defaults: Some Historical Reflections

Youssef Cassis

3 Important Questions to Ask

Are Crises more likely in Developing or Developed Economies?

Answer: Since late 1800s most financial/debt crises have occurred in *developing* countries (i.e. 1982 Latin America debt crisis)

- **Today**: threat of defaults in *developed* advanced European economies
- Since Great Depression, banking crises in *developed* economies rare
- Crisis today like a 19th century default by *peripheral* European countries
- **Key Difference**: EMU is a unique historical experience i.e. single currency of a group of politically independent countries

Are Sovereign Default Crises more likely in Different Exchange Rate Regimes?

Answer: Sovereign defaults more common under *flexible* exchange rate regimes

- EMU = *fixed* rate regime
- Defaults were more frequent before 1914 – classic age of the gold standard – carried less risk
- Peripheral countries could 'Opt in- Opt out' of the gold standard as they wanted – Argentina left in 1876 but back in 1883, left again 1885 back in 1899
- Monetary unions existed before 1914 i.e. Latin Monetary Union between France, Belgium, Italy and Switzerland (based on agreeing common rate on silver contact in low denomination coins)

Have Sovereign Debt Crises in Peripheral Countries Caused Knock-on Global Financial Crises?

Answer: Very rarely! Most common examples were limited to countries/regions

a) 1820s/1870s Latin American debt crises

b) 1876 Ottoman debt crisis (which led to the west fiddling with Ottoman finances).

c) 1918 Russian default (but did weaken Frances financial position after WW1)

Between 1890 and 1990 only **2 sovereign debt crises** could have caused a knock-on effect

International Debt Crisis (1982)

- International capital movements dominated by loans from commercial banks to the 3rd world
- Fed by depositors from oil-exporting countries i.e. 'petrodollars'
- Oil Income rocketed after oil crises of 73 and 78
- Panic in 82 – Mexico declared 3 month moratorium on debt payment
- American banks seriously exposed (thus the system)
- Crisis averted when agreement reached between banks and IMF

Baring Crisis (1890)

- Baring Brothers 1 of 2 biggest banks in London
- Bank overcommitted on loans to Argentina
- Could have collapsed following a default there
- Would have brought down other investment banks
- London banking community saved it – under orders from the Bank of England – crisis averted

World Periods of Global Finance

(1n Period 1890-1982)

Bretton Woods

(1945-1970)

***Stable** era*

- Very few financial crises

Interwar Years

(1918-1939)

***Very unstable** era*

- Many financial crises
- Last time an industrial power defaulted (Germany in 1933, downfall on Weimar Republic, Rise of Nazis)

Why Unstable? (Before WW2)

- Pre-WW1 Sovereign defaults had limited global impact
- Until 1918: Biggest borrowers = US, Canada and Russia
- Foreign government bonds held by **huge number of individual investors** NOT **large multinational financial institutions** (no coordination, lack of communication)
- Banks = Intermediaries – so, rarely threatened
- Post-WW1/2 globalisation, growth of unregulated finance, rise of large financial institutions.

12. The European Crisis: A View from the Market

Erik F. Nielsen

Different Market Views of the Crisis

(1) Anglo-Saxon View

- Majority of US/UK based investors overestimated and equated crisis to end of EZ **so they sold off €**
- Europe stood firm, this **view faded.**
- € strengthened as bail-outs were announced

Causes

5 factors

1. **Era of 'cheap money'** - World Interest rates kept too low for too long in a period of 'cheap money' (as in EMU) fuelled housing booms, erosion of productivity, increase size of public sector + rising labour costs
2. **Credit rating agencies** didn't understand the periphery imbalances and their actual creditworthiness
3. **Insufficient regulation and supervision**
4. **Lack of risk management processes**
5. **Lack of official statistics**

(2) G-7 Investor View

- **Underestimated severity** of the fiscal crises.
- EM Investors saw the severity but **underestimated the efforts** the ECB would take

(3) Real Money Investors Vs. Hedge Fund investors Views

- 'Real Money' focus on credit rating agencies (who realised the crisis late).
- Only as the crisis began to speed along did they begin to hedge

What Happened?

Past excesses + lack of reforms in a new globalised world

Policy Responses

- ECB/EU and key government reaction very good, considering trying to avoid a 'European Lehman Brothers'
- Impressive reforms in Greece, Ireland and Spain
- One concern: New 'quasi-fiscal' role of ECB – can't always act like a 'European IMF' by buying sovereign debt in secondary markets.
- National Central Banks should be left to do this

Good Shape

The EZ-17 economy as a whole, is healthy with 2/3 untouched (with a flexible competitive market)

Moral Hazard

A market based economy will not allocate capital efficiently unless **lenders know that money can be lost!** (This guides the price of loans)

Main Problems to Solve

- EU **Fiscal federalism**? Politically impossible for now and economically, not desirable (experience)
- Loans in exchange for debt service relief has better outcomes (policy reform)
- EZ polices need to be better coordinated but by domestic economies - Controlled restructuring/bankruptcy procedure needed
- Sovereign credits with vastly different fundaments should not be treated the same

Verdict?

Fine tuning needed not a major overhaul

13. How the EU Wants to Solve the Crisis – and Why This is Not Going to Work

Wolfgang Munchau

Sequence Of EU/EZ Crisis Resolution (2011-2015)

2011
- No real crisis management
- Ad hoc solutions (EFSF) 'kicking the can down the road'
- Deauville agreement (2013+)

2012
- Expected (Originally) Portugal, Ireland (PIG) and Greece reenter bond markets
- Receive follow up loan
- Exposure of private sector creditors much reduced from 2011 levels

2013
- Default? No way
- It would cut country off from capital markets risking contagion
- Likely lead to ECB recapitalisation (huge cost)
- Trigger immediate transfer payments (just cash)

2014-2015
- Most PIG debt held by EFSF or ESM mechanisms
- No private sector creditors left to 'protect' from defaulters

Greece (by 2015)
- Most of Greek debt will be held by EU/EFSF/ESM credit
- = flexibility in debt management
- ESM would become a **proper debt agency**

Italy (by 2015)
- 18% of EFSF/ESM guarantees already (2011)
- If Spain enters ESM, Italy wont honour its commitments
- Italy defaults

Spain (by 2015)
- Still engaged in adjustment
- Bank savings will be hit by continuing fall in house prices
- **ESM/IMF debt programme for** Spain likely

Germany/France (By 2015)
Grow sick of bailing out the system?

Some Realities
- Greece is insolvent
- How to fix? **Voluntary restructuring?** Oxymoron
- **Involuntary restructuring** disaster in Argentina (2002) but success in Uruguay

Eurozone
Choices

Formal Fiscal Union
Fiscal consolidation with common EZ bonds

Retreat and Breakup
End of the EZ-17 and return to competing monetary policies

Unknown Events
Likely Electoral

Finland
- Strength of Anti-EU True Finns in Finnish Parliament
- Vote against PIG EU-IMF loan tranches

Germany
- Merkel's coalition – might lose majority of ESM proposals
- German election 2013

Portugal
New Social Democrat government doesn't survive

EU
ESM ratification failure in any EU Member Parliament

France
- Downgrade of French sovereign bonds (destroy logic of EFSF based on AAA ratings)
- French Presidential election 2012

Greece
- Hasty debt restructuring or panic in Athens
- Lack of domestic political support for current/future austerity plans

Spain
General election in 2012

Postscript: The EU in 2013 – Debt Defaults and More?

Janet Kersnar

Greece in 2013

Official 'Happy Every After' Version

- EU political machine working at this
- No Greek default
- End to financial crises
- End to banking crises

Likely Version

- Another Greek bailout likely (as the likelihood of potential default increases) (See: **Skeel** article)
- Greek Default very likely (feeling of panic receding already)

Why Unlikely?

Why Likely?

Expected Greek Problems

Debt

- Greek Debt: GDP ratio expected to hit 150-170% by 2012 (nearly triple Maastricht guideline for euro entry)
- 50% will be owned by 'official sector' (EU/ECB/IMF) – so they will decide on haircuts (See: **Buchheit** article)
- Total debt: expected €340bn- need writing off or rescheduling payments (See: **Allen** article)
- Cost: 5-10% of Greek GDP on interest payments alone + austerity

Reality

This crisis is…

A **Debt** problem **+** A **Banking** problem

Greece needs money or else it will need to leave EZ – they need to print money

Solidarity or Bust?

- Eurozone (EZ) is doomed (**See**: **Calomiris** article)
- Need to make debt restructuring quicker by forcing minority bondholders to accept will of majority.
- But…the main issue is return to normal economic conditions for Greece (**See**: **Carletti** article)
  1. Quick default
  2. Exit from EZ – defaulting gov would regain monetary policy, guarantee the banking system, inflation and boost exports

Moral Hazard

To avoid moral hazard, need a EZ/EU bankruptcy framework – rules based and a 'first in time' priority system for bondholders/creditors

(See: **Skeel** article)

Lessons from History

- Many lessons from the past, 60 sovereign defaults recent years (**See**: **Buchheit** article)
- **Argentina** (2002) is the 'poster child on how a restructuring can be terrible and costly' ($95bn debt)
- Still struggling to return to international financial markets **(See: Gulati** article)
- **Uruguay** (2003) 'reprofiled' external bonds by extending the maturity of bonds by 5 years – no haircut – back in capital markets in 31 days. Different situation. (**See**: **Buchheit, Allen** articles)

31 Days (Ururguay) Vs. **10 Years+ (Argentina)**

In Greece's Favour

- Greece is set up to restructure/ default in an orderly way
- Better name: **Buchheits** 'voluntary liability transaction management'?
- 90% of debt under local law
- Haircut of 50% possible
- Politicians, creditors or taxpayers – all are now in this together