Debt Resolution in EMU

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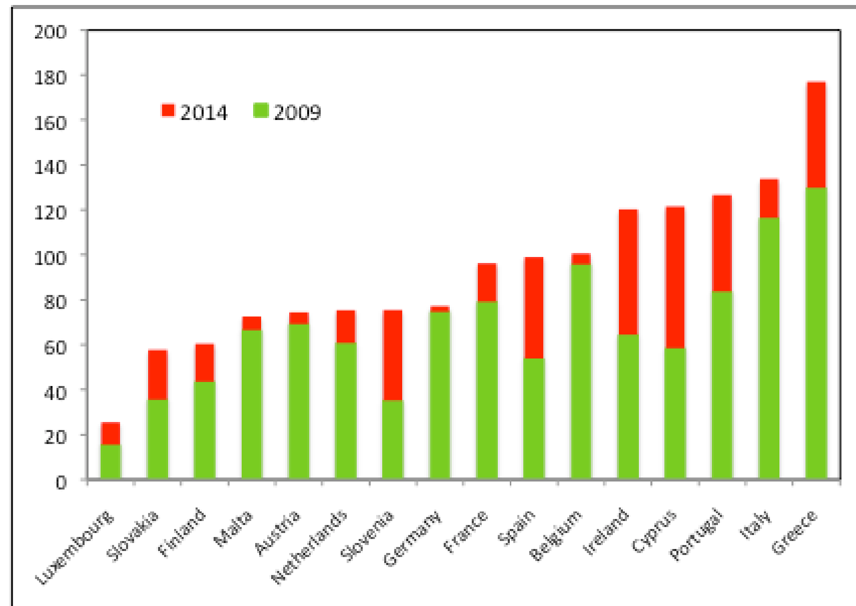
The situation

- Eurozone public debts ≈ € 9400 bn. (96% GDP)



- Situation worse now than in 2009
- Crisis: a strong case of multiple equilibria

Solutions

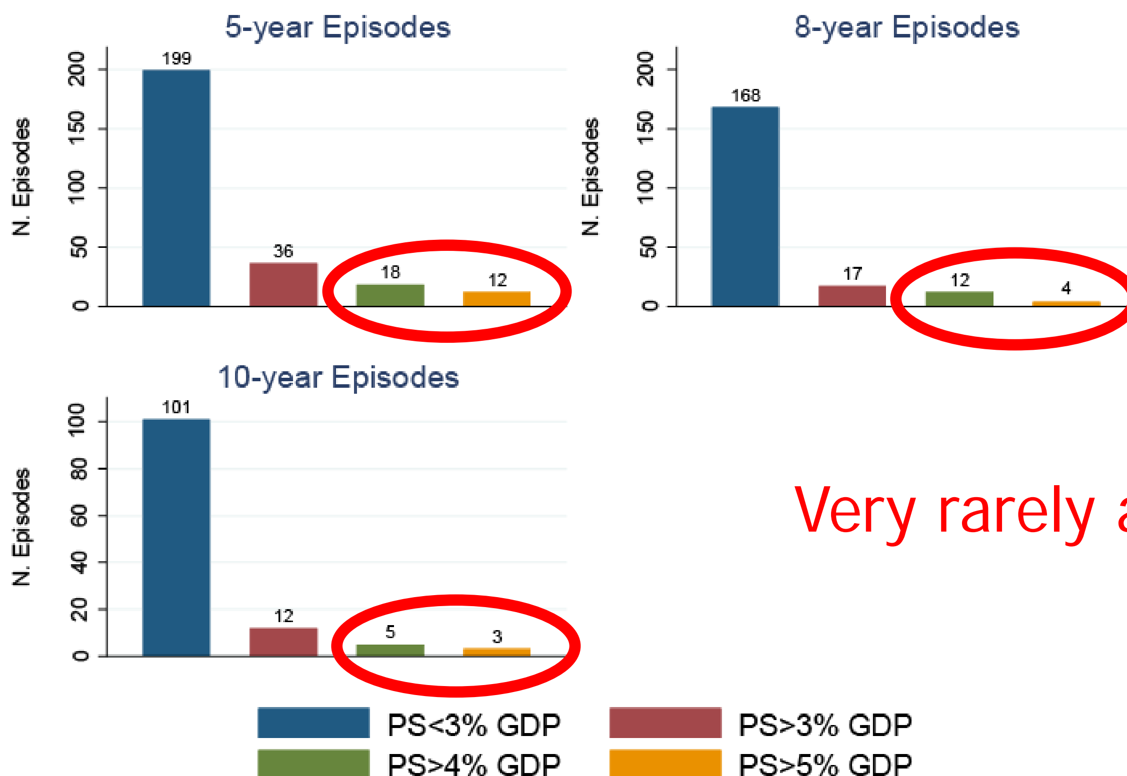
- Debts must be reduced
- Choice is:
  - Budget surpluses
  - Inflation Ruled out
  - Restructuring
  - Mutualization (monetary union specific)

Budget surpluses: the Eichengreen-Paniza calculations

- IMF objective (Fiscal Monitor, 2013)
  - 60% by 2030
  - Required average primary surplus in 2020-2030
    - Ireland: 5.6%
    - Italy: 6.6%
    - Portugal: 5.9%
    - Spain: 4.0%
    - Greece: 7.2%
- "A surplus of ambition"

Budget surpluses: the Eichengreen-Paniza calculations

- Sample of 54 countries over 1974-2013
  - Episodes of primary surpluses > 3%, lasting > 5 years



Very rarely achieved

Budget surpluses: the Eichengreen-Paniza calculations

- Sample of 54 countries over 1974-2013
  - Episodes of primary surpluses > 3%, lasting > 5 years
- Success factors
  - Growth – 12pp more likely of a 1% increase
  - Larger debts – 2pp more likely for a 10% higher ratio
  - Institutions and politics matter
- Five cases of surplus > 4% over 10 years
  - Belgium (1995)
  - Norway (1999)
  - Singapore (1990)
  - Ireland (1991)
  - New Zealand (1994)

Mutualization

- A number of proposals
  - ESBIEs
  - Red/blue bonds
  - German Council of Wisepersons (Debt redemption)
  - And more…
- Strong opposition
  - Moral hazard to be solved first…
  - … and no more any bailout clause

Debt restructuring 1: default

- Default is the default option
- If well done, no reason for leaving EMU
  - See NYC in 1970s or Detroit now
- Diabolic loop
  - Concentration of national debts in national banks
  - Bank bailouts would offset the initial debt reduction
    - No stop gap of adequate size
      - ECB would be LOLR: inflation
    - … or leave EMU
- Requires advance thinking

Debt restructuring 2: PADRE plan

- Political acceptability: no mutualization
- Financial market feasibility: no cost to bondholders
- Economic acceptability: no inflationary finance
- Financial market stability: remove large chunk of debts
  - The market failure to be dealt with
- Moral hazard must be part of package
  - The political failure to be dealt with
- Solution: pure restructuring
  - Intergenerational transfers, country by country
    - Same as primary surpluses

PADRE: a 4-step process

1. An agency agrees to redeem at maturity 50% of outstanding debts at nominal price

   About € 4700 billion

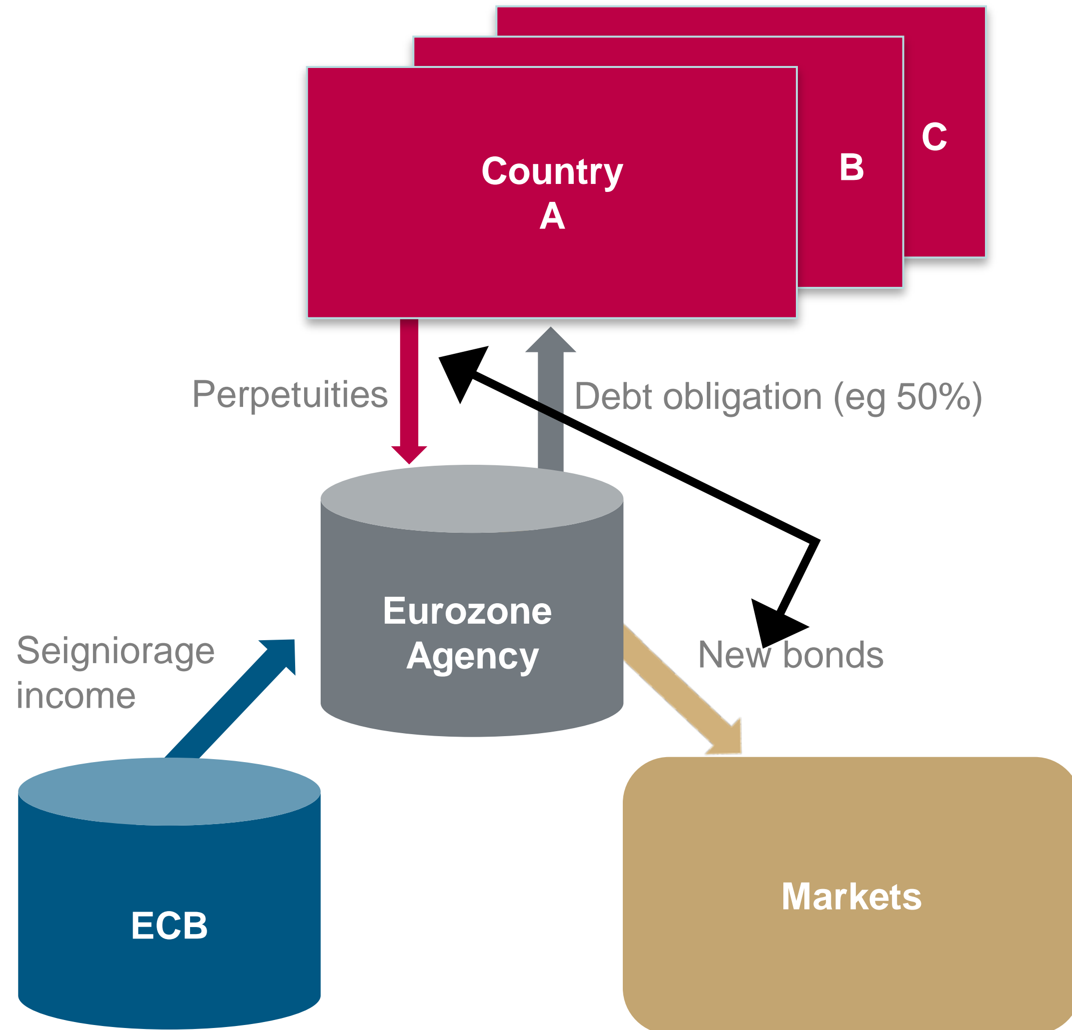
2. The agency receives zero-interest perpetuities in exchange of bonds repayment commitment

3. The agency borrows from markets

   Carry trade costs: about € 160 billion p.a.

4. Who pays?

   Each country waives its ECB's seigniorage income to the agency, until full repayment of perpetuities



Financing

- Capital shares of ECB = seigniorage income distributed to member countries

Cost to each country

Austria	Belgium	Cyprus	Estonia	Finland	France
2.77%	3.46%	0.19%	0.25%	1.78%	20.24%

Germany	Greece	Ireland	Italy	Latvia	Luxembourg
26.86%	2.79%	1.59%	17.84%	0.39%	0.25%

Malta	Netherlands	Portugal	Slovakia	Slovenia	Spain
0.09%	5.68%	2.53%	0.99%	0.47%	11.82%

- Bond purchases and swaps

Benefit to each country

  - In proportion of capital shares

- Costs = benefits, **country by country**

Results

- No transfers
  - PV (seigniorage) = Value of debt restructured
    - In the aggregate
    - Country by country (transfer across generations)
- No losses to bondholders
  - Bonds purchased at maturity
  - Instantaneous capital gains (Bulow-Rogoff, 1988)
    - Can be taxed away
- No inflation
  - Debts are not monetized

The outcome

	Initial debt (2014)		Debt reduction		Post-restructuring debt	
	€ billion	% of GDP	€ billion	% of GDP	€ billion	% of GDP
Austria	241	74.2	131	40.3	110	33.8
Belgium	394	100.5	163	41.6	231	58.9
Cyprus	19	121.1	9	57.0	10	64.1
Estonia	2	10.2	12	62.2	-10	-52.1
Finland	121	61.3	84	42.7	37	18.6
France	2026	96.2	954	45.3	1072	50.9
Germany	2186	77.2	1267	44.7	920	32.5
Greece	322	177.0	132	72.3	190	104.7
Ireland	204	120.8	75	44.4	129	76.3
Italy	2117	133.7	841	53.1	1276	80.6
Latvia	10	39.1	19	75.2	-9	-36.1
Luxembourg	12	25.4	12	24.5	0	0.9
Malta	5	71.7	4	57.2	1	14.4
Netherlands	464	75.2	268	43.4	196	31.8
Portugal	213	126.0	119	70.5	94	55.6
Slovakia	43	57.9	46	62.7	-4	-4.8
Slovenia	27	74.6	22	61.5	5	13.1
Spain	1024	98.7	557	53.7	466	45.0
Eurozone	9430	95.9	4715	47.9	4715	47.9

Easy, but…

- Can we afford it?
- Moral hazard is huge because it's so painless

Is seigniorage income sufficient?

- Financing need: € 4700 billion
- Simple calculation over infinite horizon (Buiter and Rahbari, 2012)
- Assumptions:
  - Inflation always remains 2%
  - Elasticity = 0.8

		Annual real growth rate		
		1%	1.5%	2%
Nominal interest rate	3%	14380	Infinite	Infinite
	3.5%	3899	11001	Infinite
	4%	2265	3949	9317

Country moral hazard: the covenant

- Each country signs a covenant
  - Includes a country by country debt/GDP limit
  - Ex.: Post-restructuring + 10% of GDP
- When limit reached by 1%: reverse swap
  - Agency puts perpetuities worth 1% of GDP for cash forcing new country bonds issuance
  - Not discretionary
- Any further 1% excess: further conversion
- Immediate market / rating sanctions

Collective moral hazard: the covenant

- Collective moral hazard
  - Like in 2010: a bailout of some sort for one country?
- Any such decision to be voted upon
  - Countries that refuse a deal: excused from loss
  - Potential losses from any change to be shared only by those who vote in favor

Conclusions

- Why does it work?
  - Deals with inefficiencies
    - Growth and policy externalities
    - Multiple equilibria (runs on debts, runs on banks)
    - International externality but political objections to internalization
  - Designed to strengthen fiscal discipline
- Feasible and many variants
  - A blueprint, not a fully worked out plan