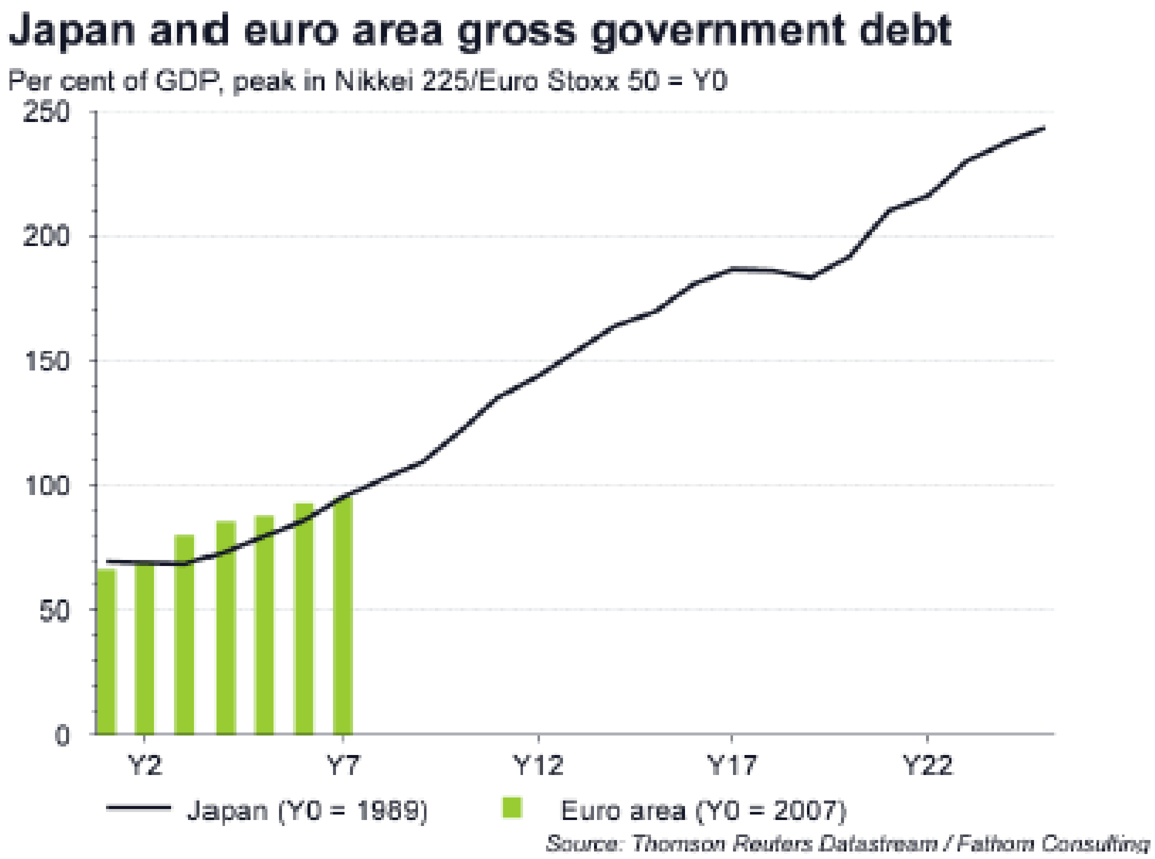
The (no so) funny part

The scary part



The danger of high debt

- Tax on growth
- Runs on sovereign debt possible
- Bail in “impossible”
- Doom loop

Spillovers !

New Institutions and Policies for a workable Eurozone:

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

PRELIMINARY

Florence, November 27, 2014

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Proposal

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

One-off coordinated policy

- **to decrease the legacy debt *(debt buy-back and relief)* in exchange for:**
- **a permanent improvement of the fiscal governance of the euro area (*the new fiscal regime*)**
- **a structural solution to the diabolic loop and creation of safe asset**

The no – nos …

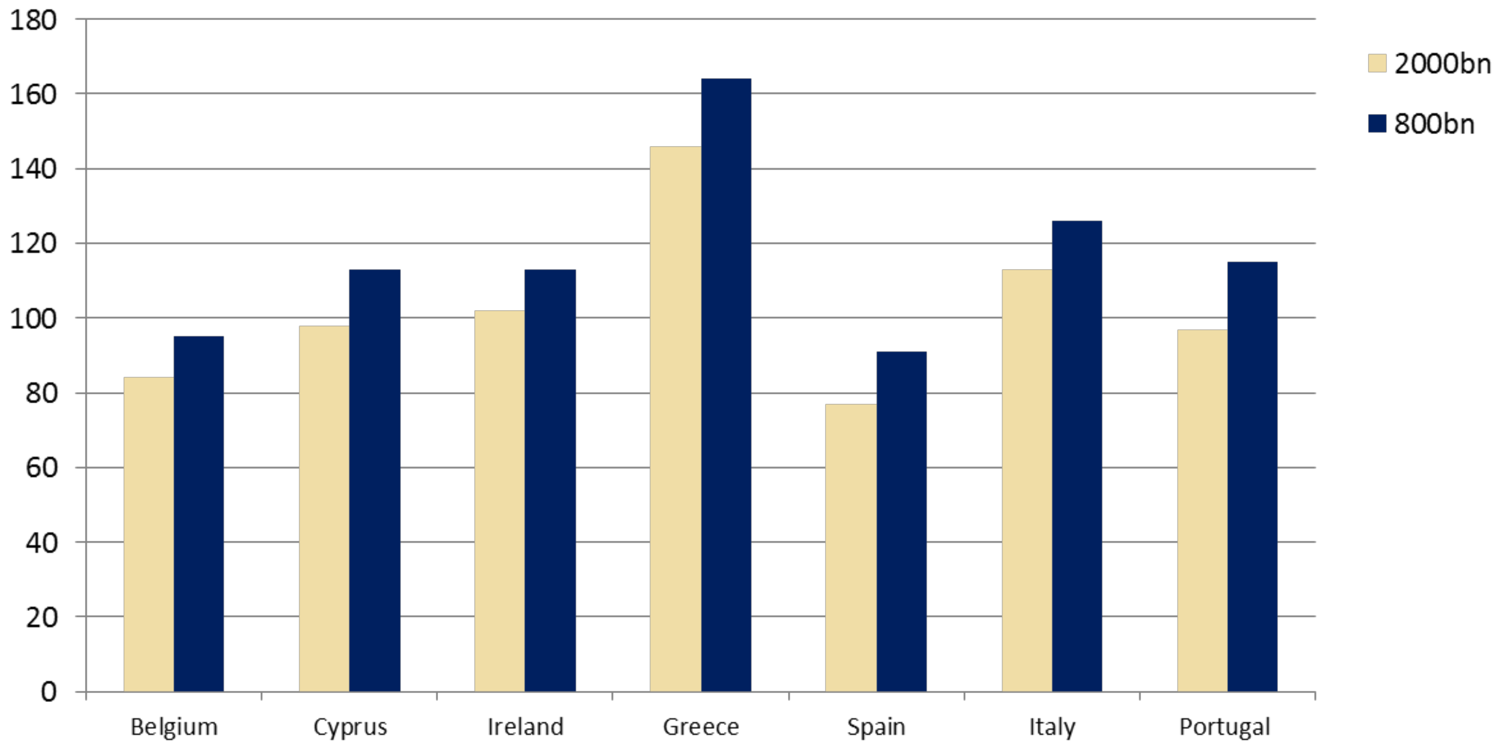
- No debt mutualization
- No inflationary pressure
- No pressure on the ECB

- No repetition of the stock operation
- No more over borrowing
- No more socializing of bank losses

- Some redistribution (intra-generational, cross-border)
- Possibly some bondholder losses

I. Stock operation: Debt Buy Back from Seigniorage

Debt/GDP after buy back of 50 year non-inflationary seigniorage revenue : Two scenarios yielding 800 or 2000 billion euro, distributed with ECB key



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.

I. Stock operation: Debt relief

Seigniorage revenue (NPV over 50 years) is not enough to bring all countries under the debt threshold

Additional measures needed:

- **Allow for redistribution of seigniorage, i.e. non ECB keys or**
- **Each country defines an additional revenue source to cover shortfall or**
- **Fiscal equalization scheme, e.g. add-on to euro area VAT, bring forward over the next 50 years, redistribute per capita**

II. Strengthening the fiscal regime with a Sovereign Debt Restructuring Regime

Why a restructuring regime?

1. **Ex post: to reduce the costs of debt crises**

2. **Ex ante: to create incentives for crisis prevention, by increasing market discipline for countries with poor policies.**

   - **Solve the commitment problem**
   - **Larger in the Eurozone due to spillovers**

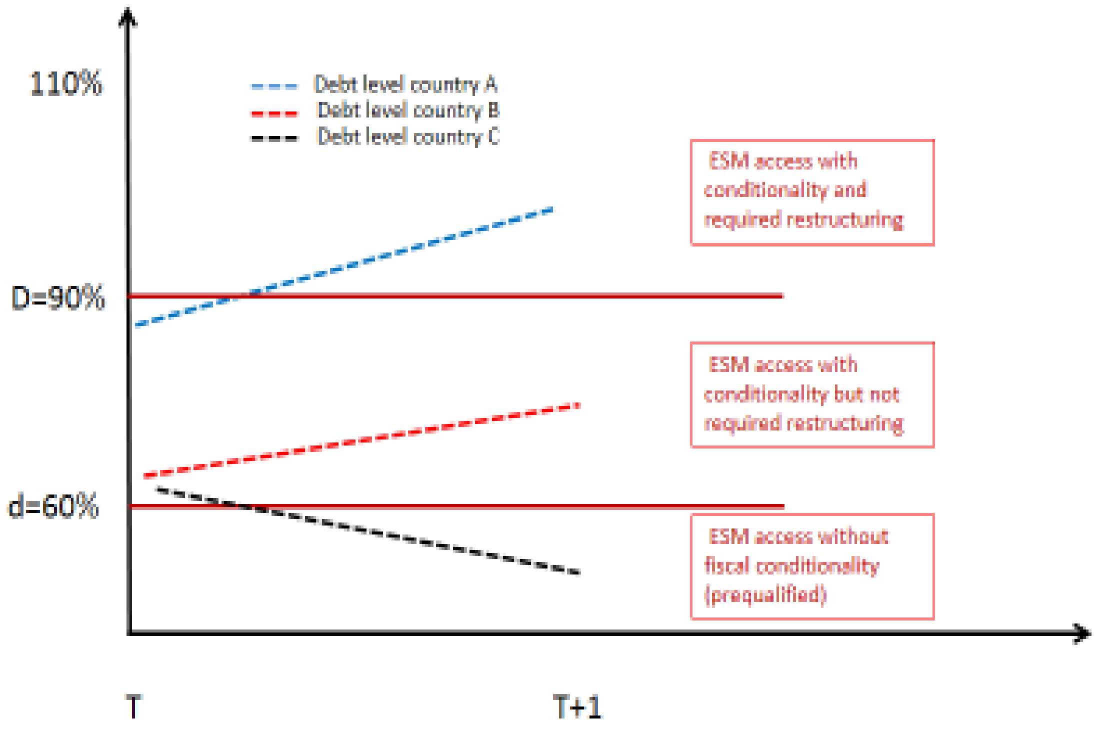
II. Addressing the commitment problem by conditioning bail out on bail in

Amend ESM policies (akin to lending framework of IMF). But with stronger binding of the hands, i.e. automatic triggers

Example:

- **ESM financial support to countries depends on two thresholds of debt to GDP: d/D**
- **Above upper threshold D with debt restructuring**
- **Below lower threshold d, pre-qualification for access**
- **Between d and D, present regime**

II. Example


110%
D=90%
d=60%
T
T+1
Debt level country A
Debt level country B
Debt level country C
ESM access with conditionality and required restructuring
ESM access with conditionality but not required restructuring
ESM access without fiscal conditionality (prequalified)

Not a walk on the beach…
But a package with the stock operation

III. Immunizing the financial system

Regulation:

- **Single borrower limits**

- **Capital requirements: risk free weighting only for portfolios of sovereign bonds (equal to its share in Eurozone GDP),**

- **Liquidity coverage ratio: dito**

- **Monetary policy: ECB announces it would buy and sell only in sovereign bonds only in fixed proportions**

Financial markets will issue synthetic assets in these proportions. Safe asset through tranching (similar as Brunnermeier et al., 2011)

Conclusion

Address the moral hazard problem created by debt relief

- **by reforming the euro area governance so that the no bail out clause can be credibly enforced; incentives to discourage excessive debt are restored since countries can default in an orderly way,**

- **by delinking the bank and sovereign balance sheets; default becomes feasible, since systemic effects will be more limited.**

Conclusion

3 Reforms

- are strongly complementary,
- they address both the debt overhang in the short run and incentive problems for the long run,
- could generate both stability and welfare improvements if implemented jointly.

Thank you for your attention

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