

Sovereign Risk and the Euro

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Introduction

The economic and financial crisis – the worst since WWII – has produced an unprecedented increase in public deficits and debts in all advanced economies

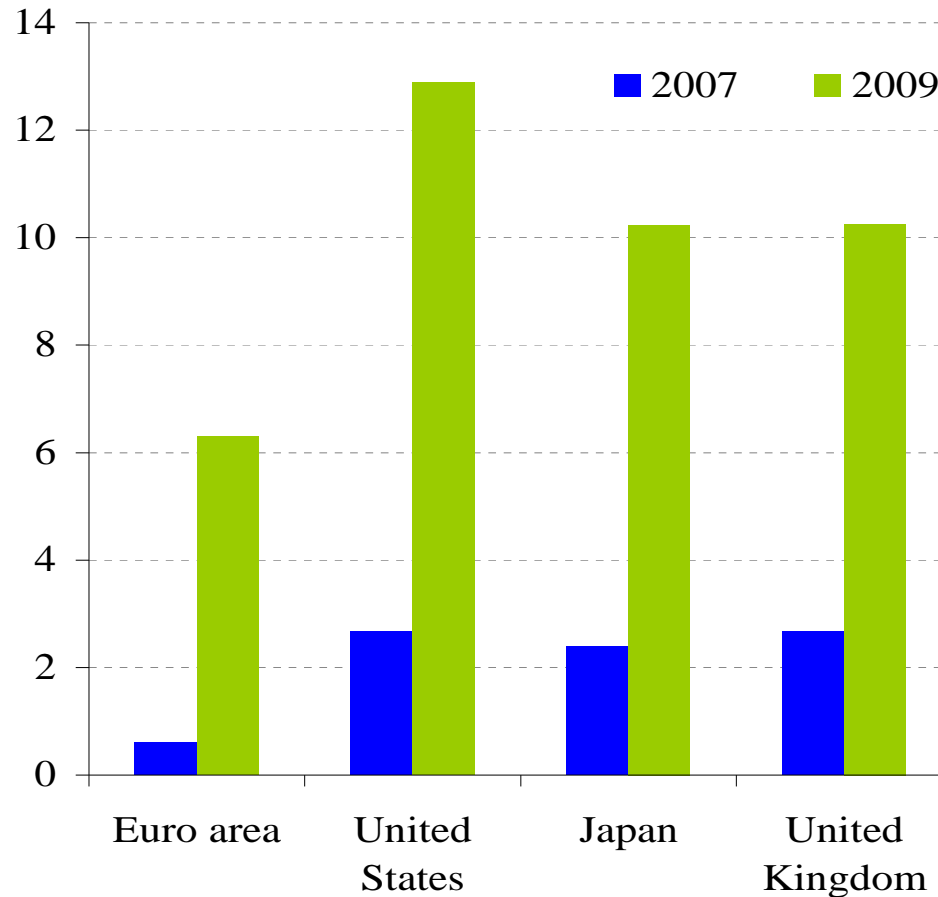
The ability of these countries to take the necessary actions to bring the public debt under control is being increasingly challenged, also by financial markets

The challenge has started in the euro area

Government deficits have increased everywhere

General government deficit

(as a percentage of GDP)

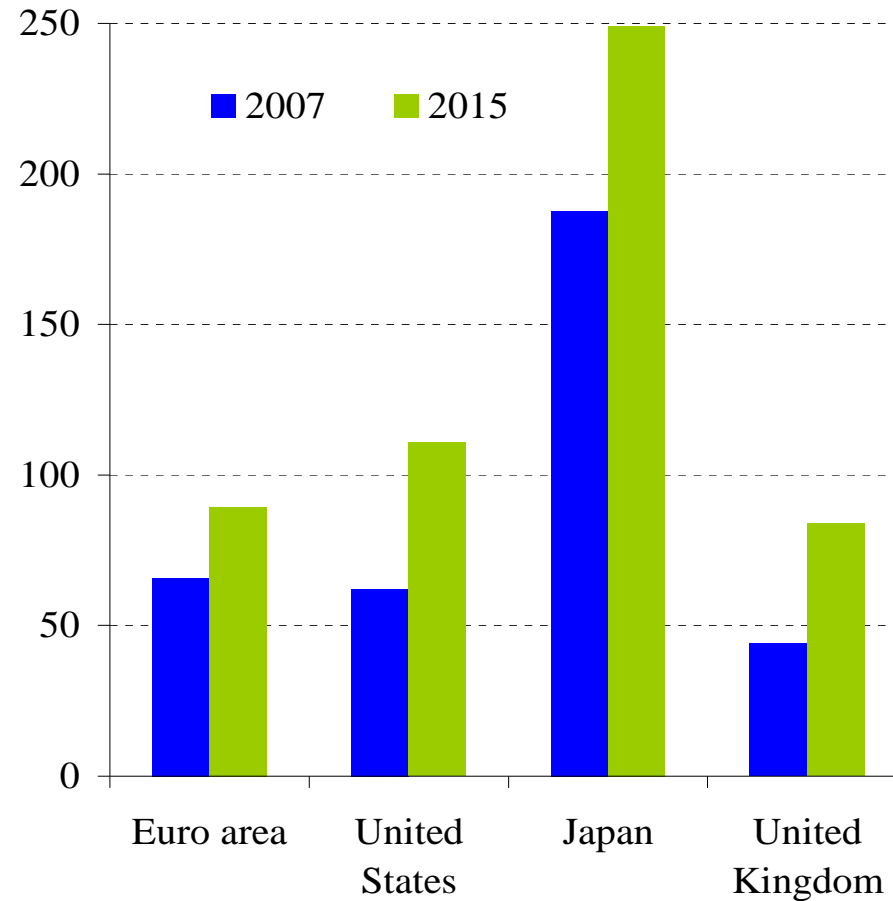


Source: IMF WEO October 2010

And so has public debt

General government gross debt

(as a percentage of GDP)

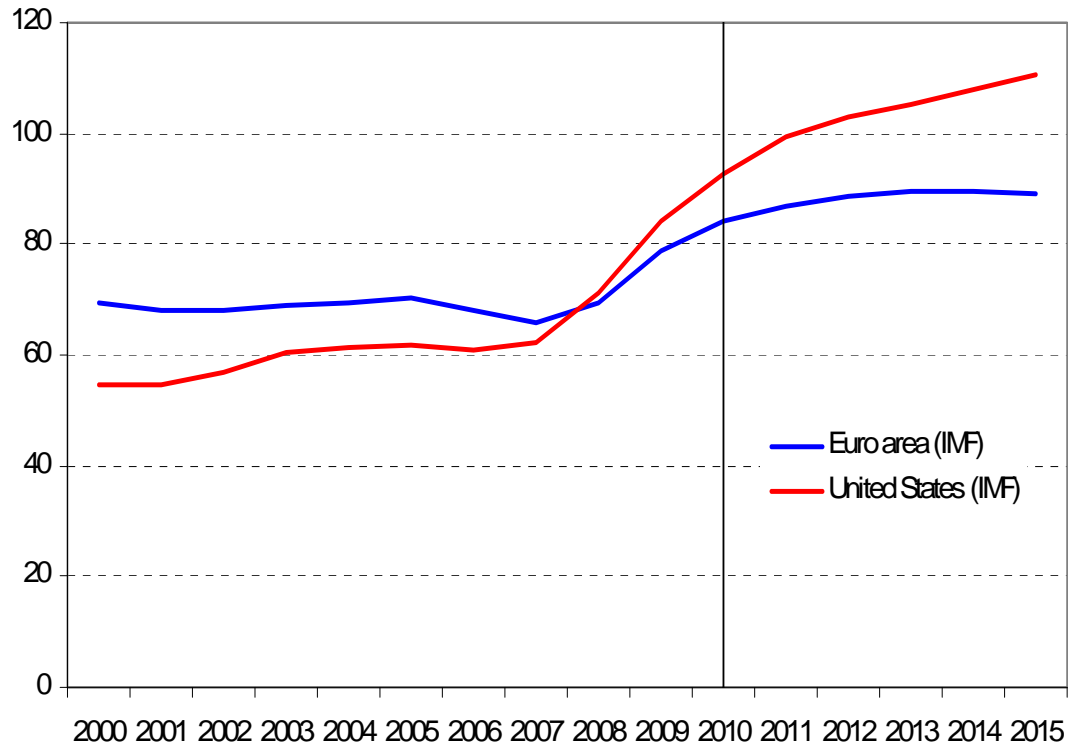


Source: IMF WEO October 2010

Stabilisation of the debt in 2013

General government gross debt

(as a percentage of GDP)

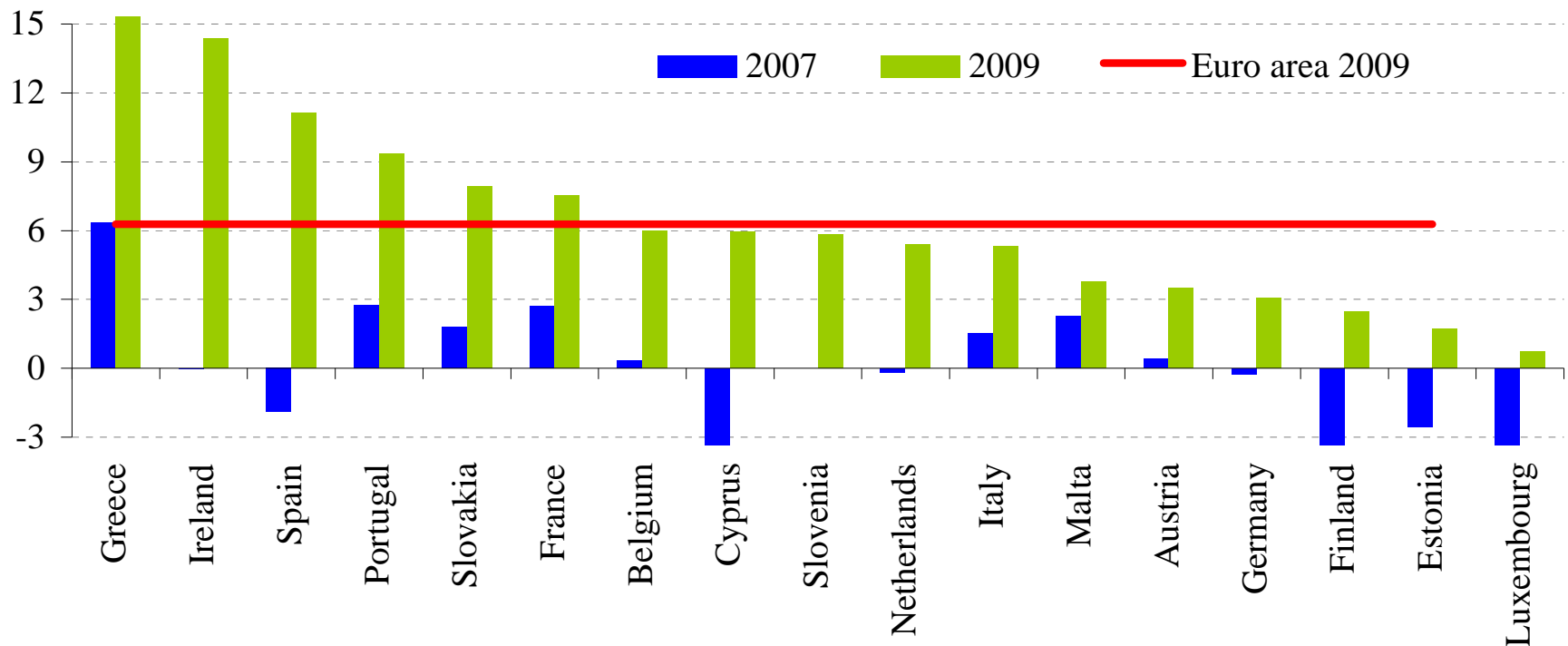


Source: IMF WEO October 2010

Within the euro area the dispersion is large

General government deficit

(as a percentage of GDP)

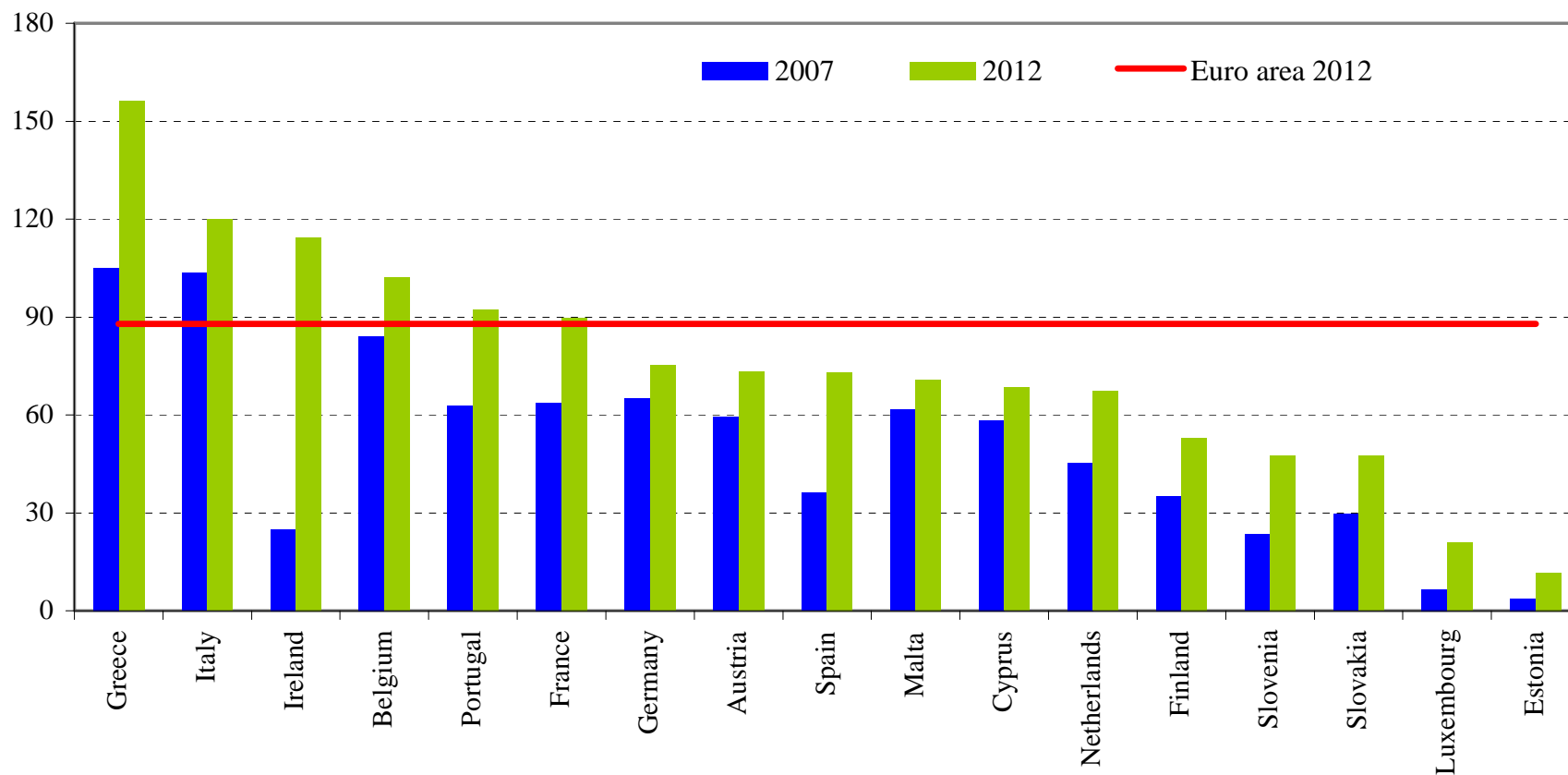


Source: European Commission's economic forecast autumn 2010

Also in terms of debt

General government gross debt

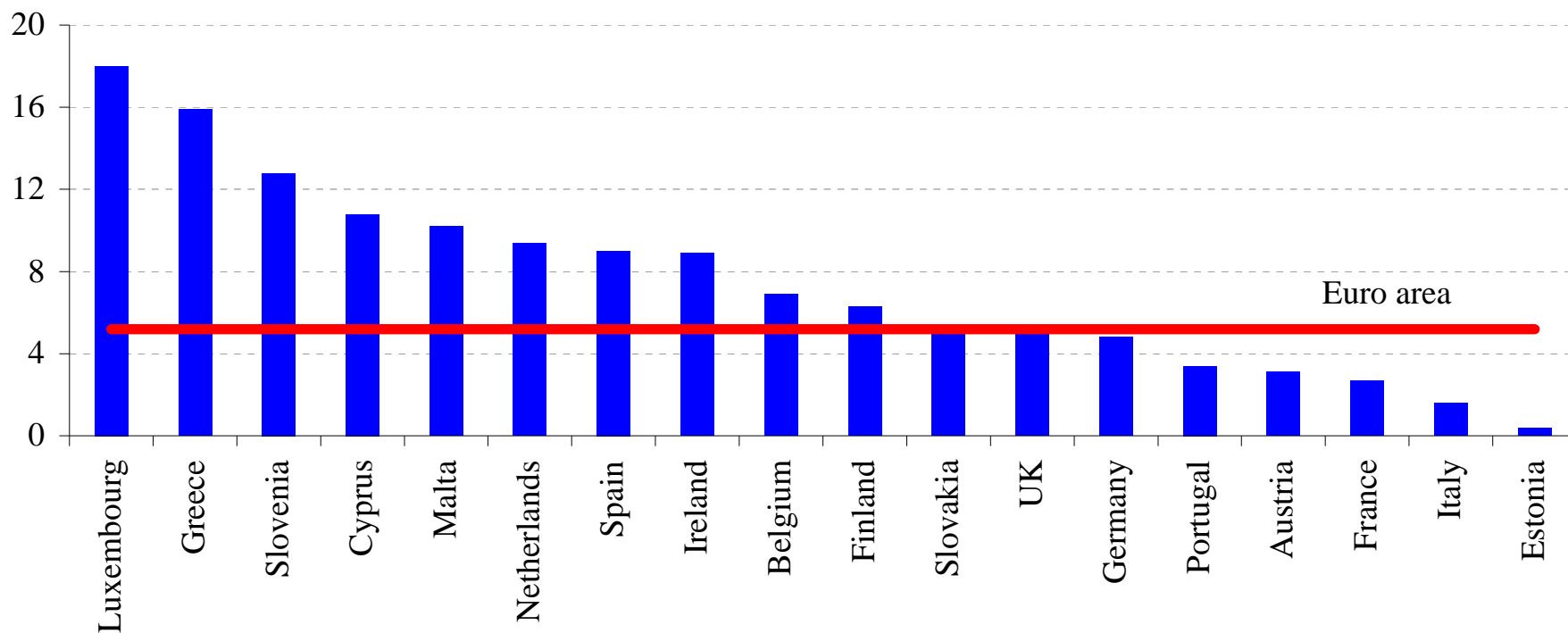
(as a percentage of GDP)



Source: European Commission - Autumn 2010 Forecast

And ageing is bound to make things worse

Projected change in age-related government expenditure, 2007-2060
(percentage points of GDP)



Source: European Commission Ageing Report 2009

NB: Some countries have, in the meantime, introduced pension and/or health care reform which should reduce long-term increases in age-related spending

Three ways to reduce the debt burden

A: Fiscal adjustment

B: Inflation

C: Default / Restructuring

...or a combination of the above

In the euro area inflation is ruled out

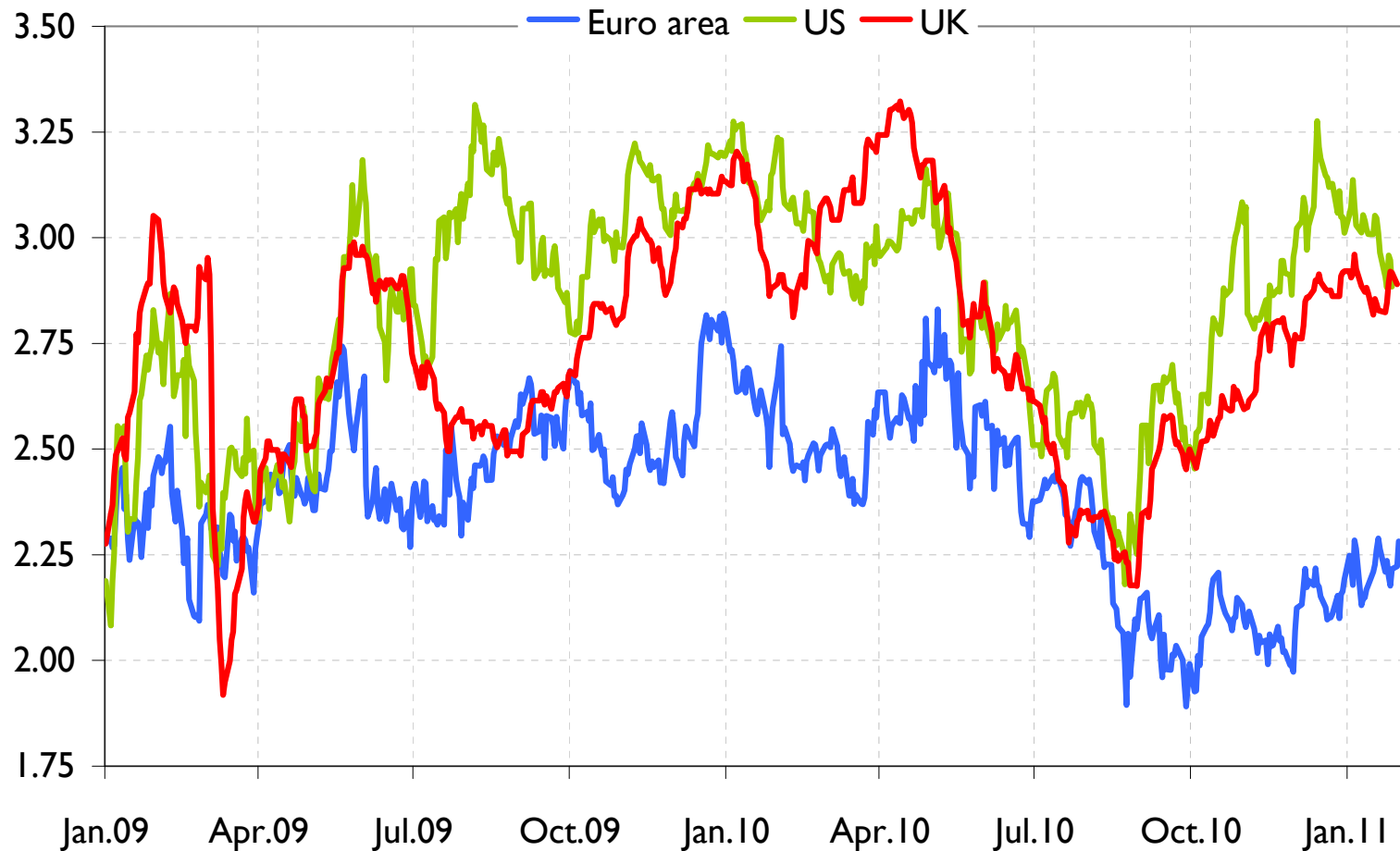
The Treaty requires the ECB to ensure price stability

Monetary financing is prohibited

...and markets trust it

Inflation expectations remain well anchored

Five-year forward break-even inflation rate five years ahead

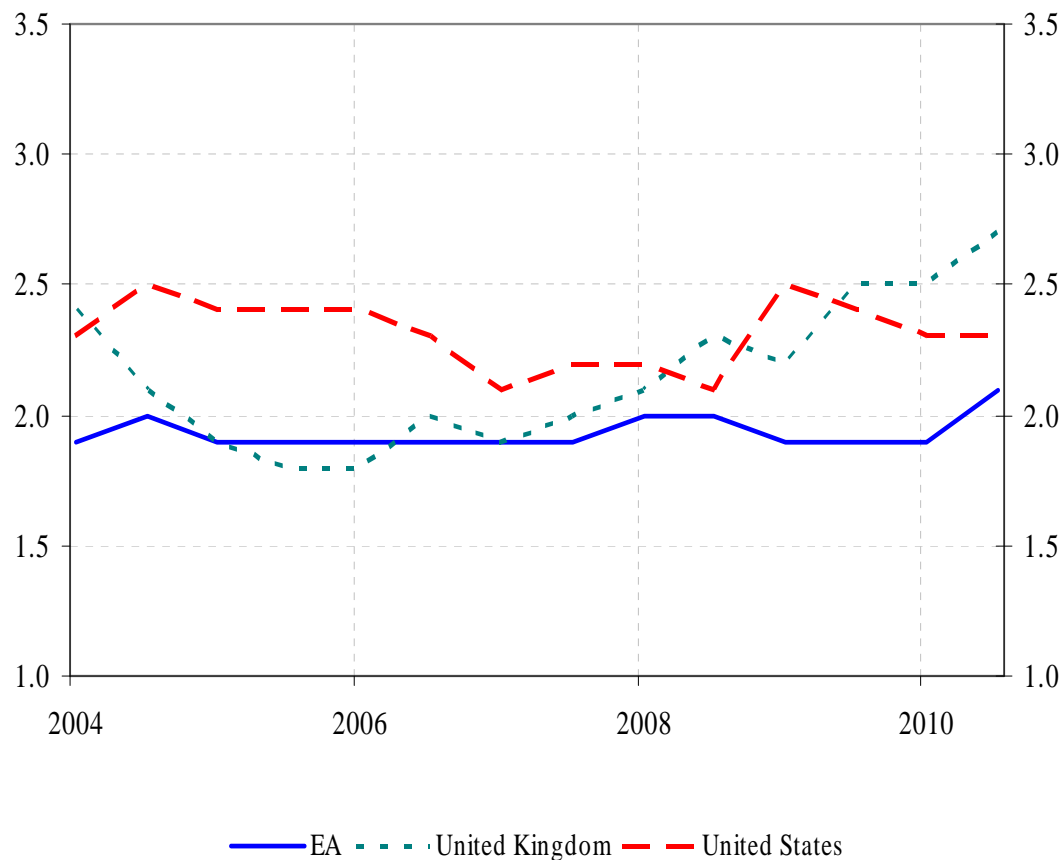


Sources: Reuters, ECB, Federal Reserve Board staff calculations, Bank of England

Also in surveys of professional forecasters

Inflation expectations six to ten years ahead

(annual percentage change)



This leaves only two ways

Plan A: Fiscal adjustment

Plan B: Default / Restructuring

Euro area countries have opted for Plan A

All euro area countries have programmes to reduce the deficit/GDP to below 3% by 2012-2013

Greece and Ireland are implementing EU/IMF adjustment programmes

IMF, EU and EU countries are providing Greece and Ireland with unprecedented financial assistance

EU countries have created the EFSF and changed the Treaty to create the ESM in 2013

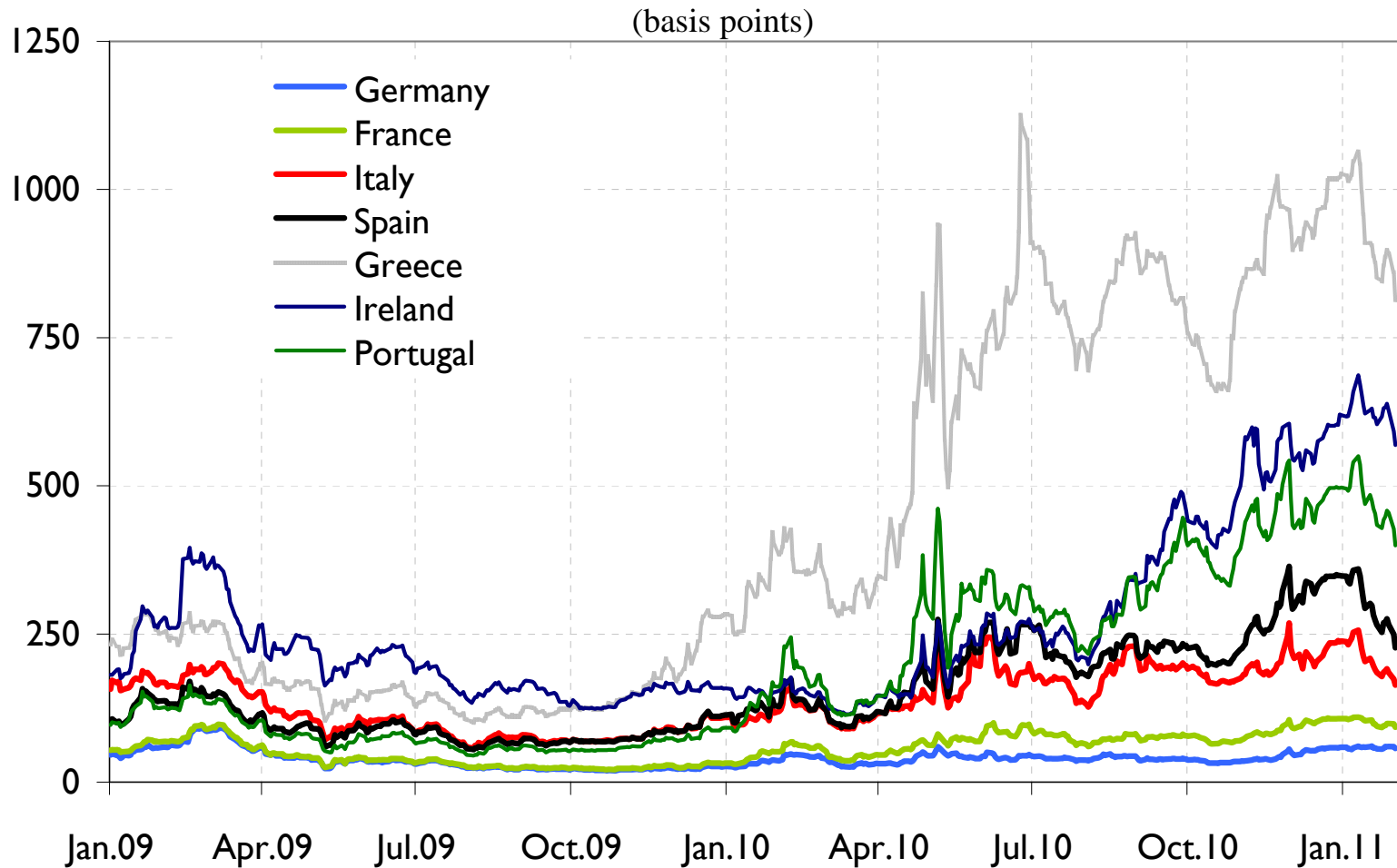
The reasoning is the following:

- 1. The required fiscal adjustment is too costly**
- 2. It cannot be politically sustained**
- 3. EA solidarity will not hold**

- 4. Therefore the only solution left is “Plan B”:**
 - (partial) default/restructuring**
 - Exit/split the euro**

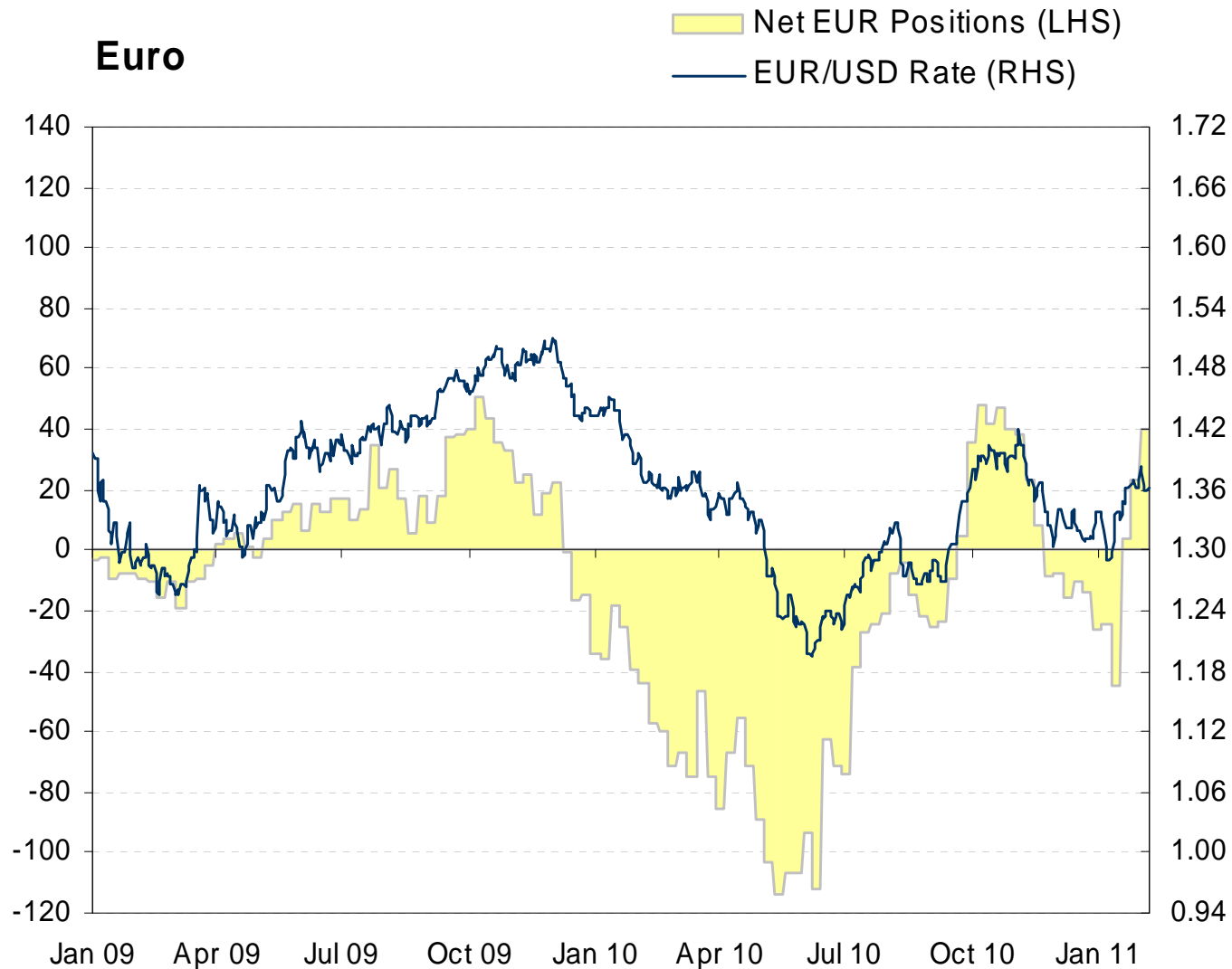
Markets have reflected these doubts

5-yr Sovereign CDS Spreads



Source: CMA DataVision via Datastream

Also affecting confidence in the euro



Source: Commodity Futures Trading Commission (CFTC)

What's missing in the reasoning?

Plan A is considered “too costly” but there is no assessment of the costs of Plan B

In fact, Plan B is itself extremely costly, in economic and political terms

Plan B can be more costly than Plan A:

- For the country itself**
- For the other euro area countries**

A closer look at Plan B

Plan B has been implemented only in developing countries

Over the last 20 years, 19 countries out of 120 IMF programmes had debt restructuring:

1998	Ukraine, Russia, Pakistan, Venezuela
1999	Gabon, Indonesia, Pakistan, Ecuador
2000	Ukraine, Peru
2001	Argentina, Cote d'Ivoire
2002	Moldova, Seychelles, Gabon
2003	Dominican Republic, Paraguay, Uruguay
2004	Grenada
2005	Dominican Republic
2006	Belize

The experience shows

Plan B has large reputation / penalty costs

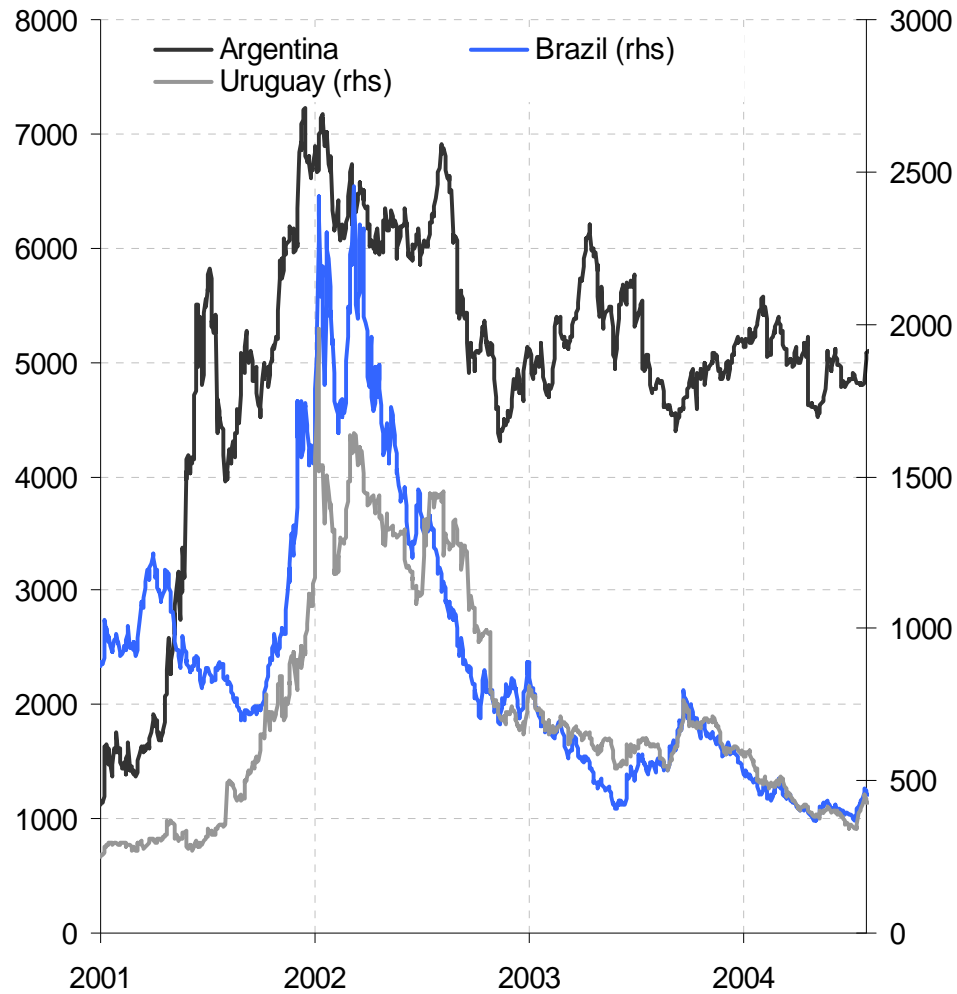
- **Loss of market access**
- **Higher future borrowing costs**
- **Trade sanctions by creditor countries**

Broader costs to the domestic economy

- **Output losses**

High borrowing costs and contagion

Evolution of the EMBIG spreads around crisis episodes (in basis points)



Source: Haver Analytics.

EMEs' experience is not a good guide

The experience of the emerging market economies (e.g. Brady plan) cannot be directly applied to the current situation in advanced economies

Default in EMEs was typically the result of a foreign exchange crisis, which increased the burden of the foreign debt in an unsustainable way

Fiscal adjustment was unsustainable as it fuelled exchange rate depreciation, which increased the burden of the debt

EMEs' experience is not a good guide (2)

The default/restructuring of the debt in developing countries mainly affected foreign creditors

When domestic creditors were involved, very restrictive measures were implemented through administrative and capital controls (e.g. *corralito* in Argentina)

Restructuring/Default in advanced economies

Affects domestic residents' wealth:

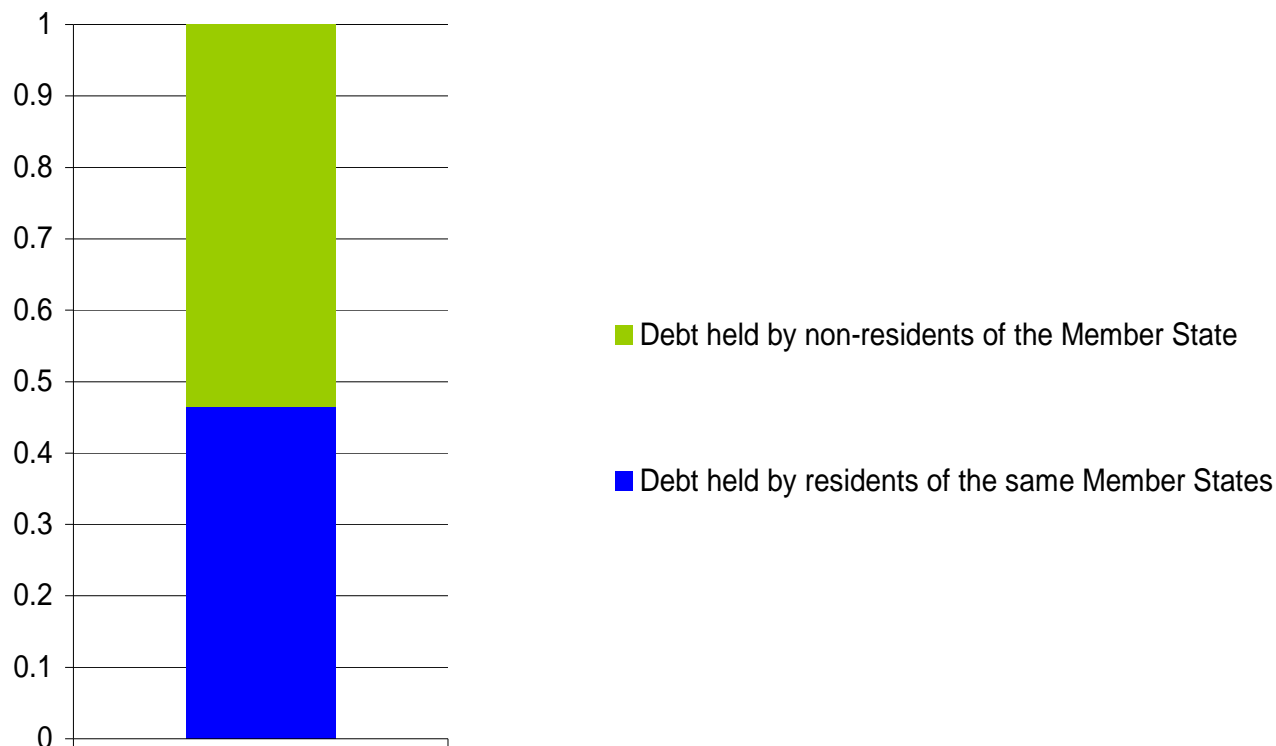
- **directly through the holdings of government debt by the private sector**
- **indirectly, through the role played by government guarantees in the financial sector**

Produces strong contagion in other countries

Residents hold a large share of government debt

Euro area: holdings of government debt by residents and non-residents (end 2009)

(share of total debt)



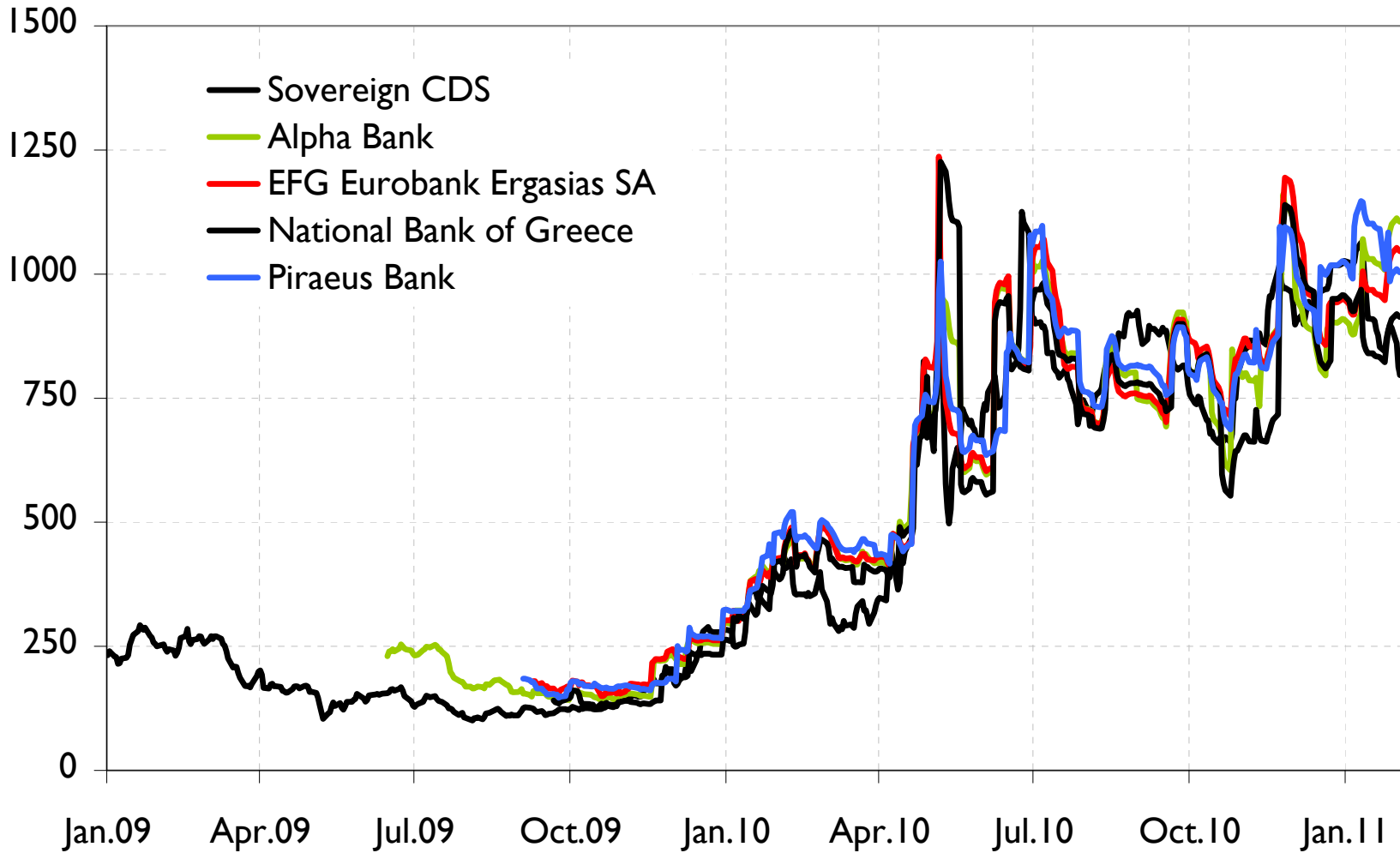
Source: ECB

Impact on the domestic financial system

A restructuring of sovereign debt has a direct effect on the solvency of domestic financial institutions *inter alia* through:

- direct holding of government debt**
- access to collateralised credit**
- government guarantees**

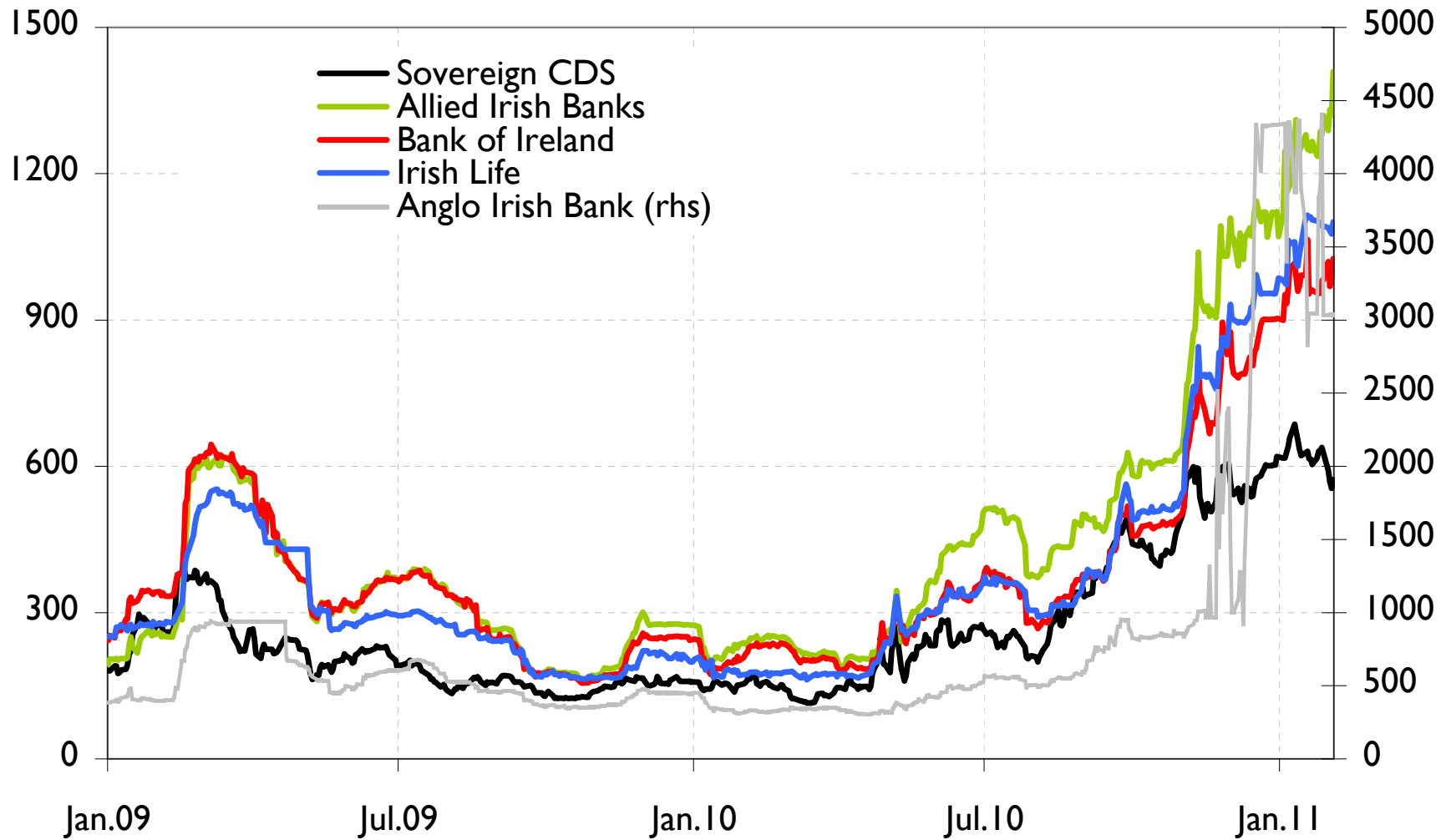
As shown by the strong correlations: Greece



Latest observation: 3 Feb. 11. Note: Five-year CDS; basis points.

Source: CMA DataVision via Datastream

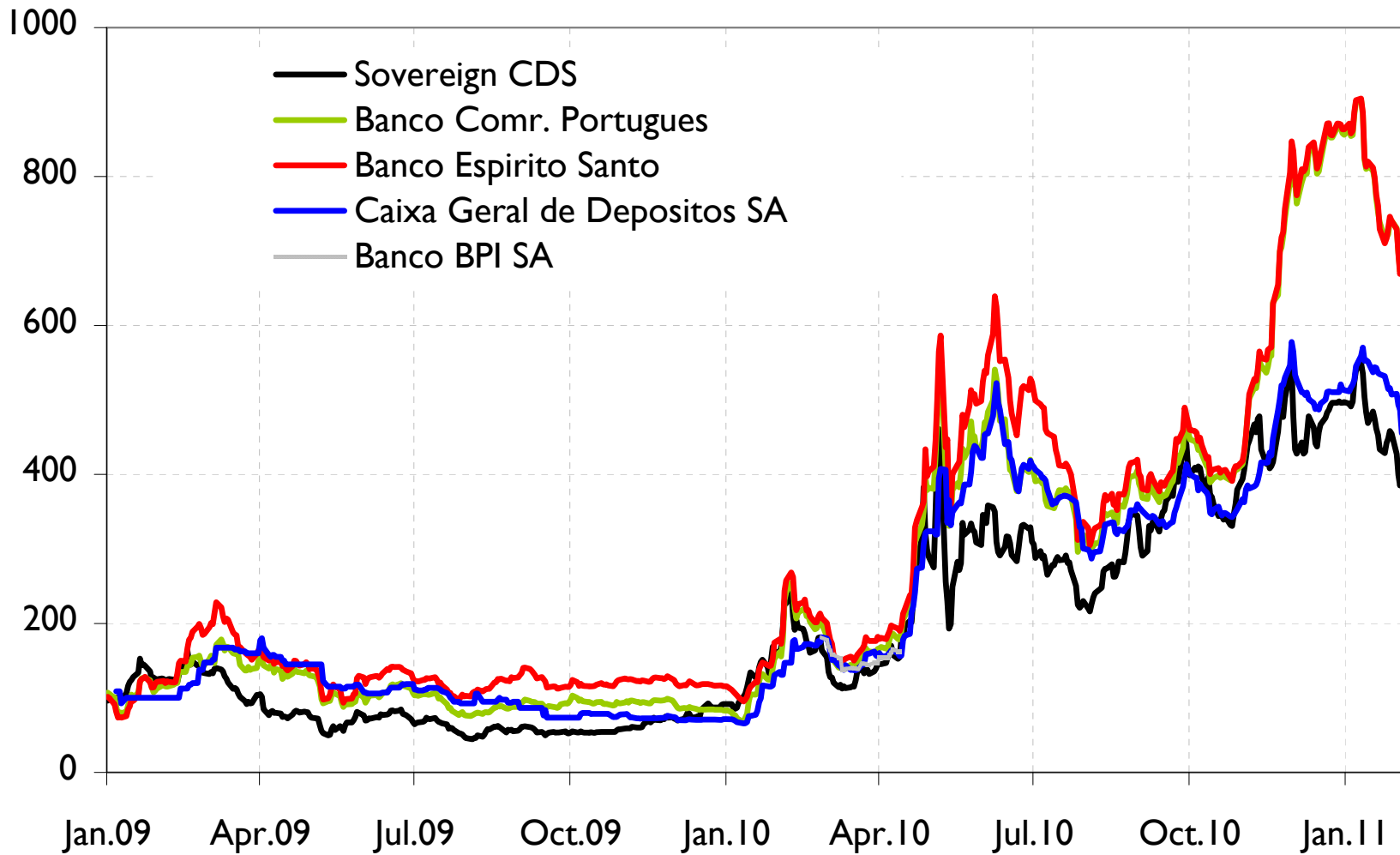
Ireland



Latest observation: 3 Feb. 11. Note: Five-year CDS; basis points.

Source: CMA DataVision via Datastream

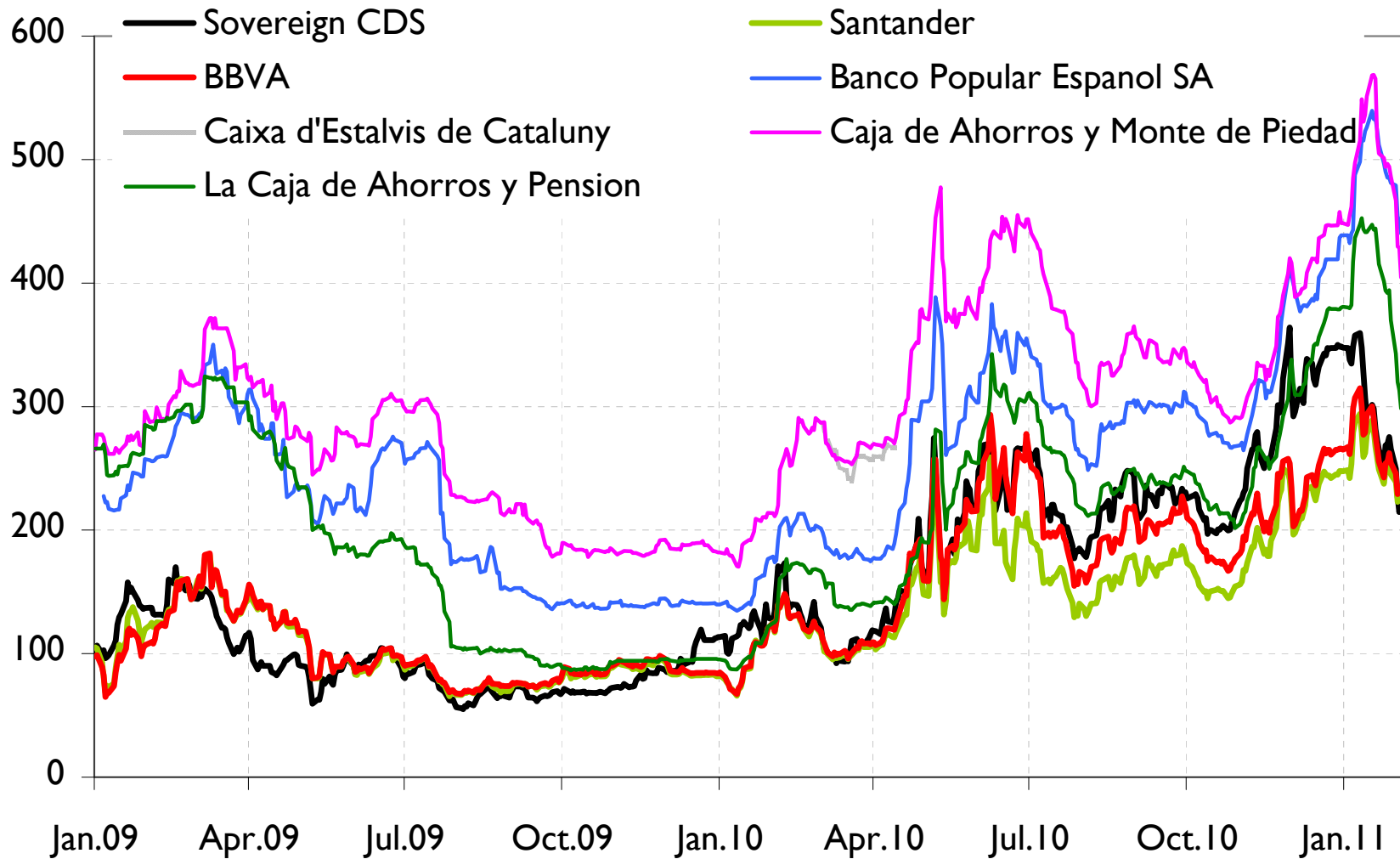
Portugal



Latest observation: 3 Feb. 11. Note: Five-year CDS; basis points.

Source: CMA DataVision via Datastream

Spain



Latest observation: 3 Feb. 11. Note: Five-year CDS; basis points.

Source: CMA DataVision via Datastream

Effects on the banking system

A sovereign default/restructuring produces major losses for domestic banks and fuels a bank run by depositors, which triggers:

- Administrative measures, capital controls**
- Restructuring of bank liabilities (bonds, deposits..)**
- Credit crunch**

Effects on the real economy

Very sharp contraction, through:

- **Direct wealth effects**
- **Credit crunch**
- **Non market measures**

Social/political repercussions difficult to assess

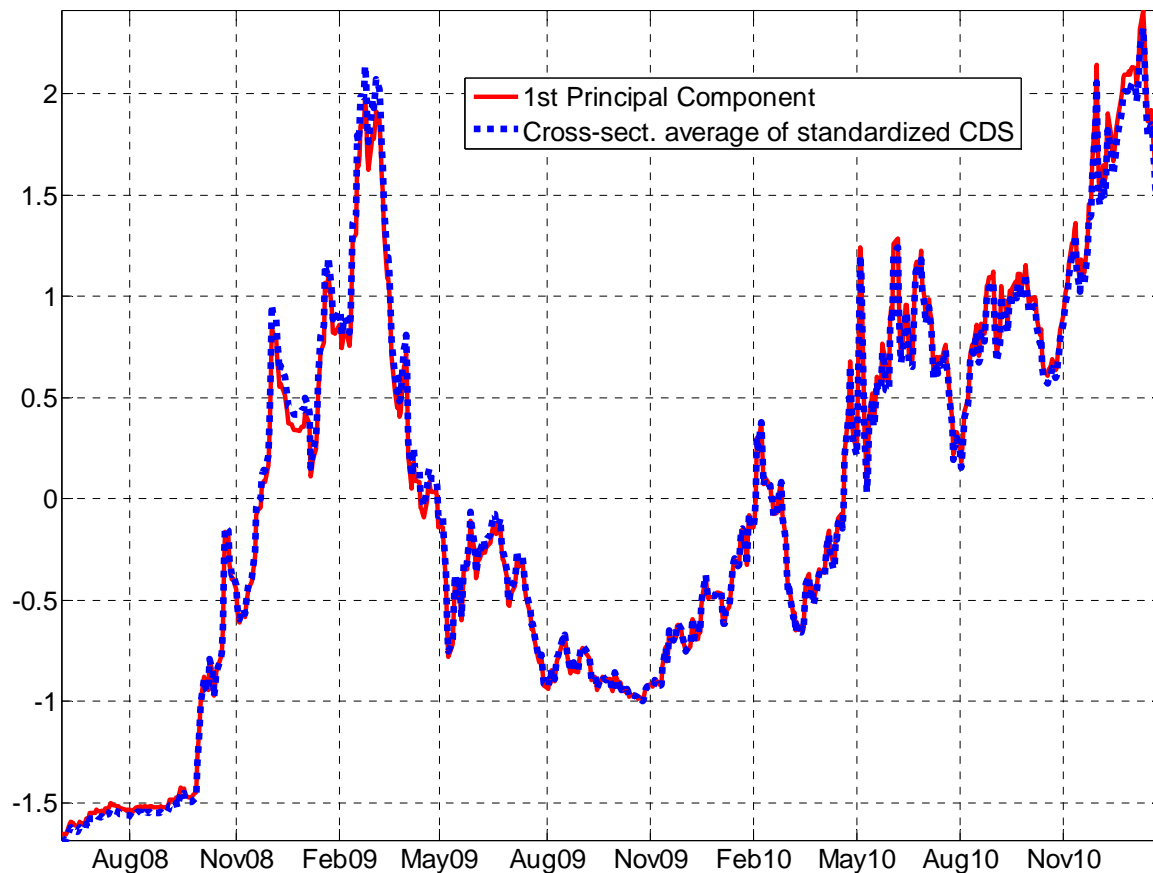
(it's not by chance that default/restructuring has occurred mainly in non-democratic systems)

Contagion

Default/restructuring in one country tends to produce immediate contagion effects in other countries

This would impact on financial stability in the euro area as a whole

Contagion



Source: Datastream and ECB calculations

Note: basis points, last observation 27 Jan 2011. Extracted from daily data on 5-year euro area sovereign CDS. CDS series and the Principal Component are standardized.

Would exiting the euro make it easier?

The fear of exiting the euro would accelerate the bank run by domestic residents (to withdraw euro)

The domestic banking system would lose access to euro area financial market and to ECB refinancing, and would have to reduce in parallel its assets

The redenomination of financial instruments in new (devalued) currency would trigger cross-border litigation but possibly also within the country

The country would lose access to EU facilities and funds

Is there an “optimal timing”?

When primary balance is achieved, and thus the government does not need to tap the market

The negative impact of Plan B is not lower while most of the costs of Plan A have been paid (especially politically)

When markets are better prepared (now?)

The experience of Lehman Brothers' collapse, which was anticipated for some time, shows that markets are never fully prepared for such a systemic event

To sum up

Plan B implies:

Restructuring → Wealth effect → Demand shock

**Impact on the banking system → Investment
→ Lower capital stock → Supply shock**

Plan A implies:

Increase in primary surplus → Demand shock

Plan A

Plan A is made on the basis of an assessment that the country is solvent

Plan A consists of:

- 1. Fiscal and structural adjustment in the member state to ensure debt sustainability**
- 2. Reform of the governance of euro area to safeguard stability in the euro area**

Assessing solvency

The solvency of a sovereign is different from that of a company or a financial institution

Solvency of a sovereign depends on ability/willingness to implement the adjustment programme, against any alternative scenario

In particular, the ability/willingness to:

- tax (personal, corporate, special..)**
- cut expenditure**
- sell assets**

Debt sustainability analysis

The adjustment programme defines a primary budget surplus which would stabilise and reduce over time the debt/GDP, on the basis of:

- the interest rate level**
- growth**
- the level of debt**

Debt stability conditions

Primary balances needed to stabilise debt-to-GDP ratio

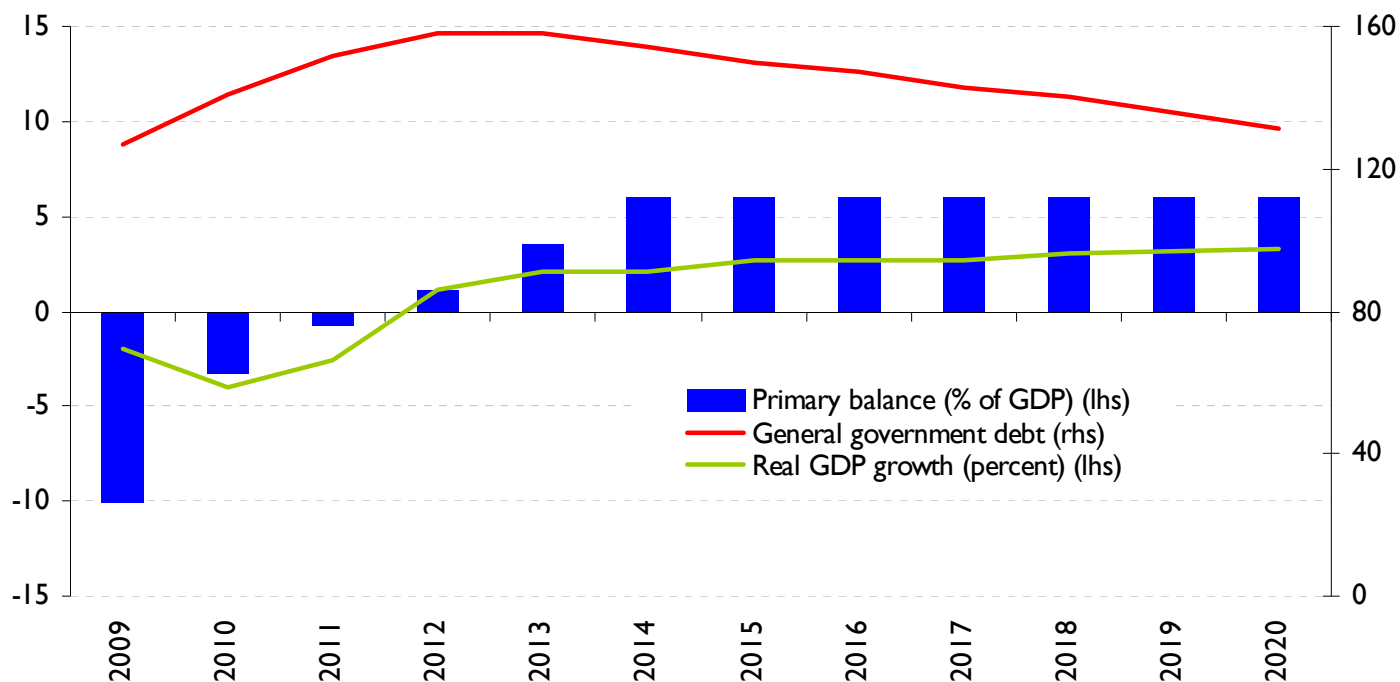
	Spain	Portugal	Ireland	Greece
Debt-to-GDP ratio projected for 2012*	73.0	92.4	114.3	156.0
r-g				
2	1.5	1.8	2.3	3.1
4	2.9	3.7	4.6	6.2
6	4.4	5.5	6.9	9.4

*European Commission autumn 2010 forecast

Primary balances needed to stabilise the debt-to-GDP ratio (at the level projected by the European Commission for 2012) in the long-run (steady state) under different assumptions for the interest rate-growth differential

The adjustment is substantial: Greece

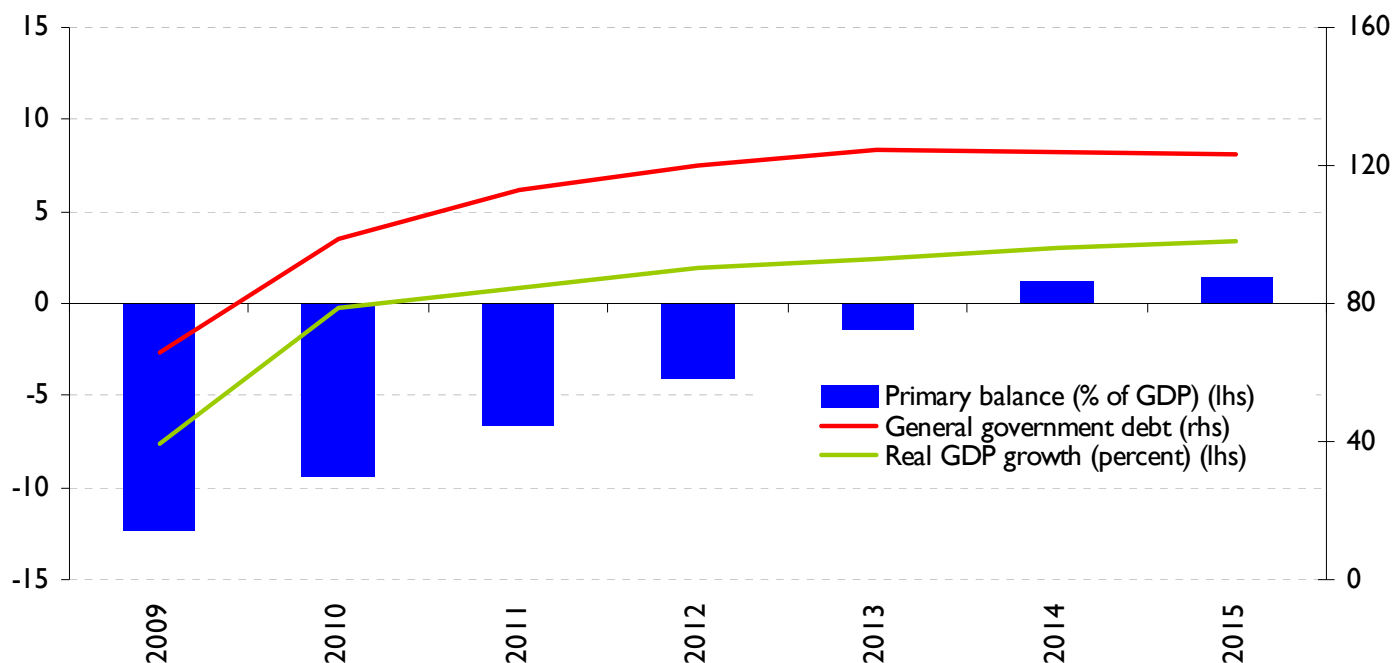
Greece: projected general government debt and primary balance under current EU/IMF programme (percentage of GDP)



Source: IMF - Second review under the Stand-By Arrangement

And in Ireland

Ireland: projected general government debt and primary balance under current EU/IMF programme (percentage of GDP)



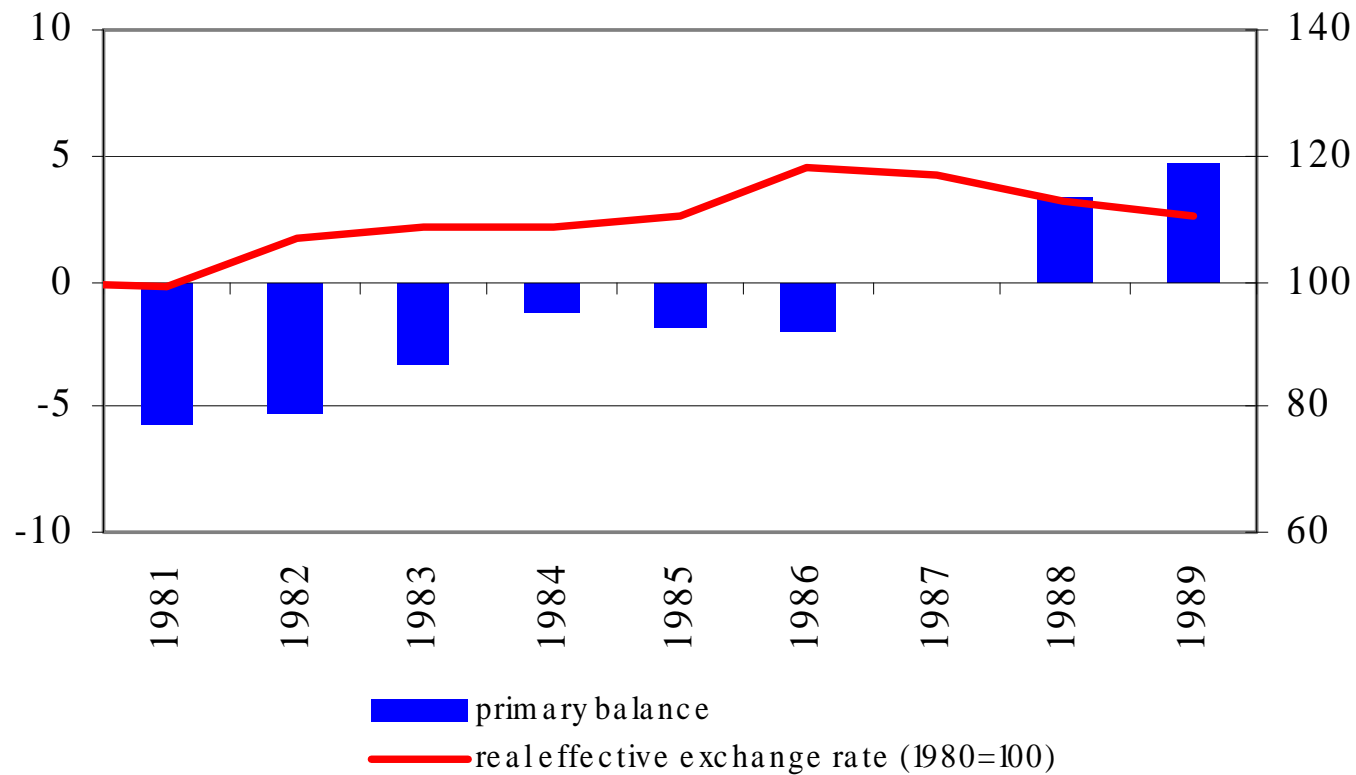
Source: IMF - Staff Report - Request for an extended arrangement

The primary balance figure for 2010 has been corrected for the one-off impact of government support to Irish banks

But not unprecedented

General government primary balance (as a percentage of GDP)

Ireland



The interest rate level

The interest rate on the programme is aligned with IMF rules and procedures

Interest rate \pm 6% can ensure debt sustainability

What is key is the rate at which countries have borrowed, from the market or through the IMF/EU programme

If successful, the Program can be lengthened (standard procedure in the IMF)

EFSF could be made more effective, e.g. linking the interest rate to performance (while remaining non-concessional)

The debt level

The higher the debt level, the higher the primary surplus required to stabilise the debt

However, a primary surplus is needed in most cases

In the case of Greece, the primary surplus required to stabilise and reduce the debt after 2013 is $\pm 6\%$

If the debt were cut by one-third, the primary surplus would still be relevant

Debt stability conditions (repeat)

Primary balances needed to stabilise debt-to-GDP ratio

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Debt-to-GDP ratio projected for 2012*	73.0	92.4	114.3	156.0
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Restoring sustainability

The previous slide shows that if the primary surplus needed to achieve sustainability is considered too high because the market interest rate is high, there are two ways to restore sustainability:

- reduce the interest rate burden (and lengthen the maturity), while keeping it non-concessional**
- haircut on debt**

For (official) creditors the first solution is preferable because it involves no capital loss

Market ways to reduce the debt burden

Under discussion: buy back at market prices (lower than nominal), by the member state or through the EFSF, subject to strict conditionality

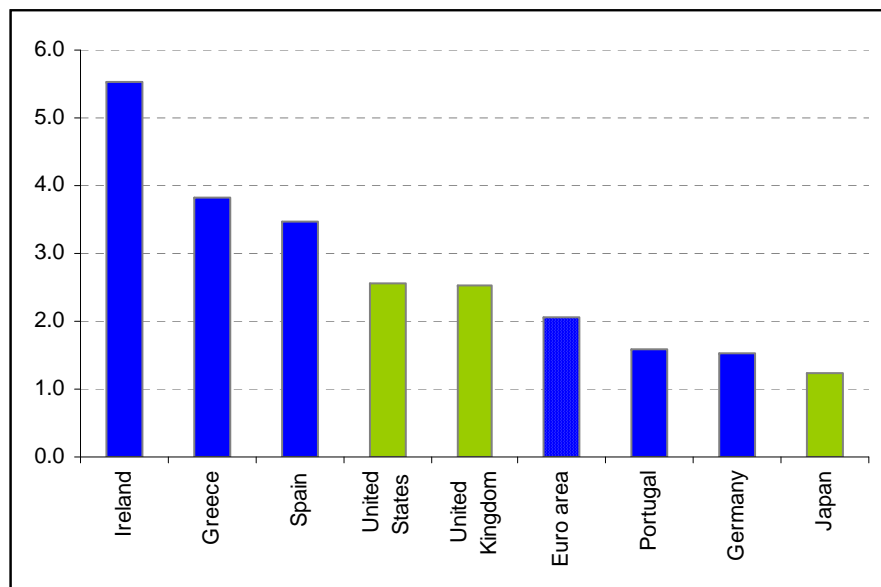
Win-win situation:

- reduces the debt burden**
- provides market liquidity**
- short-term investors can sell (at a loss)**

Restoring pre-crisis growth will be difficult

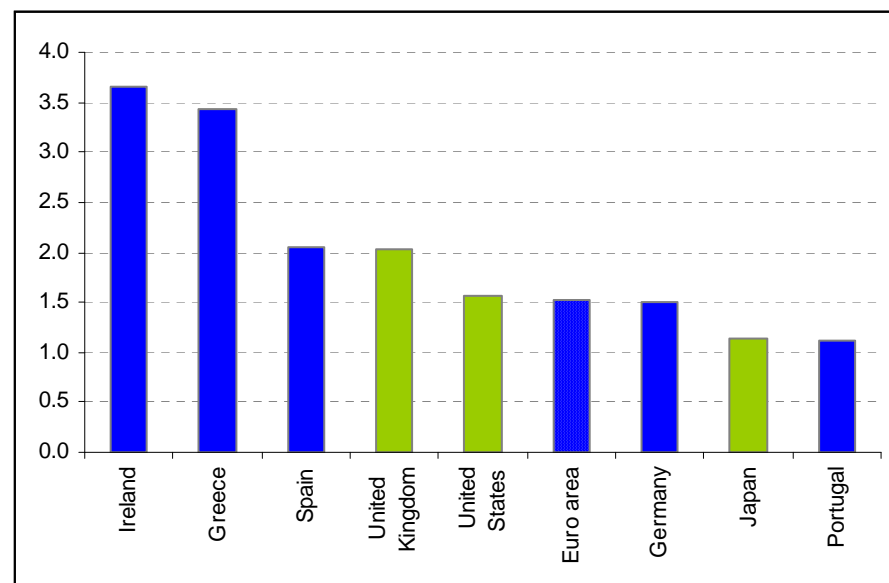
Real GDP

(average growth 1999-2008)



Real GDP per capita

(average growth 1999-2008)



Source: European Commission's economic forecast autumn 2010

Note: Real GDP per capita refers to gross domestic product at 2000 market prices per head of population.

But growth is key

Restore competitiveness

- mainly through domestic adjustment

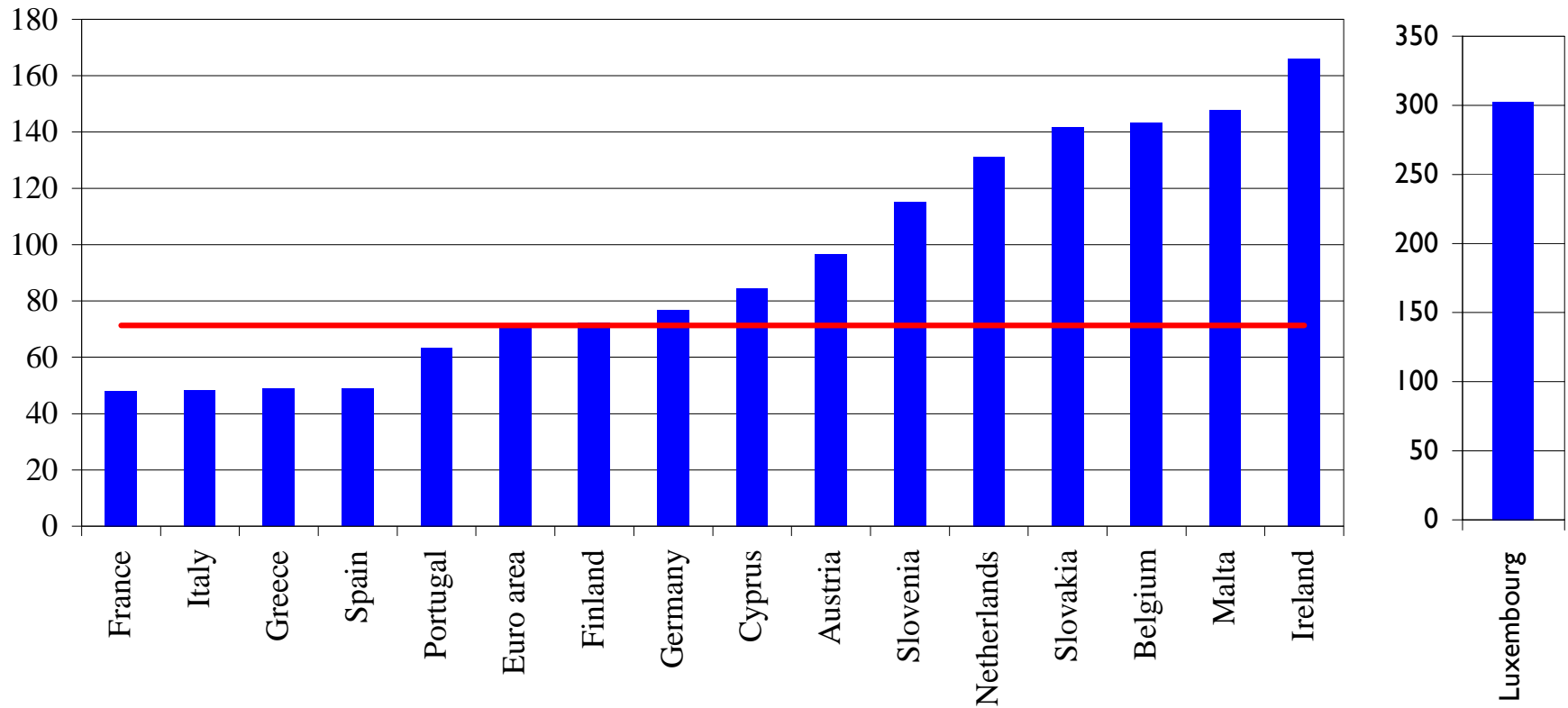
Lack of exchange rate flexibility

- not an excuse

Structural reforms are essential

Devaluation is no panacea

Trade openness across euro area countries (exports plus imports in % of GDP, nominal)



Source: European Commission

Structural reforms start to be implemented

Greece

Competition and productivity

- **Deregulation of transport and energy sectors**
- **Opening up of closed professions**
- **Implementation of Services Directive**
- **Restructuring of state-owned enterprises and bringing in of private management**

Labour market flexibility and labour supply

- **Reduction of employment protection**
- **Facilitating use of part-time work/flexible work arrangements**
- **Reform of the arbitration system**

Pension reform

- **Extensive reform to improving long-run sustainability**
- **Simplification of fragmented system, with universal, binding rules on contributions and corresponding entitlements**
- **Increase in retirement age to 65 and contributory period for full pension from 35 to 40 years**

Ireland

Financial system:

- **Stabilise and downsize the banking sector**
- **Improve solvency and funding of viable banks**
- **Quick resolution for non-viable banks**
- **Increase confidence in viable banks by fully recognising losses in loan portfolios**
- **Burden-sharing by holders of subordinated debt**

Product and labour markets

- **Reduction of the minimum wage**
- **Reform of the unemployment benefits system**
- **Deregulation of sheltered sectors of the economy**

Portugal

50 structural measures announced mid-December 2010 to be legislated by end-March 2011, including:

- **Fostering the export sector and investment in R&D with tax incentives**
- **Reducing administrative burdens of the export sector**
- **Strengthening wage flexibility and reducing overall employment protection**
- **Improving the rental market**
- **Reducing the size of informal economy**

Spain

Product markets

- **End 2009: transposition of Services Directive**
- **Early 2010: streamlining of procedures for business creation**

Labour market

- **June 2010: improvements to some aspects of hiring system and collective bargaining, improving firms' flexibility**

Spain

Pension reform

- **January 2011: approval of draft pension reform bill, agreed with social partners, including gradual increase in the retirement age (from 65 to 67) and increase in contributory period for full pension (from 15 to 25 years)**

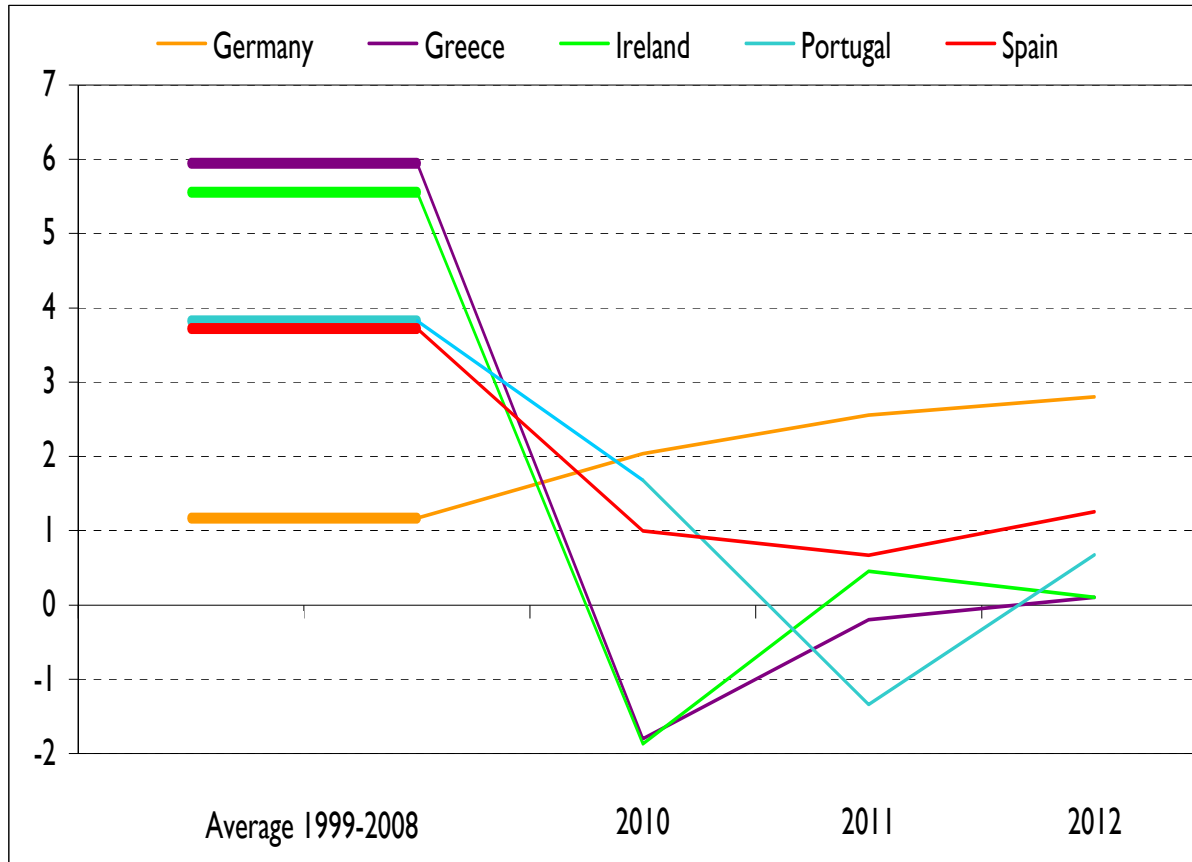
Financial system

- **Mid 2010: restructuring of the “cajas de ahorro”, reform of legal framework, extension of options for issuing equity capital**

The impact on competitiveness is starting

Compensation per employee

(Annual % changes)



Source: European Commission (Autumn 2010 forecast).

European governance has evolved

In less than one year:

Financial support for Greece (April 2010)

Creation of the EFSF (May 2010)

Reform of the SGP (October 2010)

Change in the Treaty for ESM (Dec 2010)

“Comprehensive Package” (March 2011)

If not sufficient...“We will do what is needed”

Why so slow?

Fiscal adjustment and governance reform are costly in the short term, from an economic and political view point

Governments tend to take the political cost only when they can explain to their constituencies that the alternative (default, euro instability) is much more costly

The evidence that the alternative is more costly emerges only under the pressure of the markets

Action has been delayed

Greece
Spread over German 10-year government bond yield
(2009-2010; daily data; in basis points)

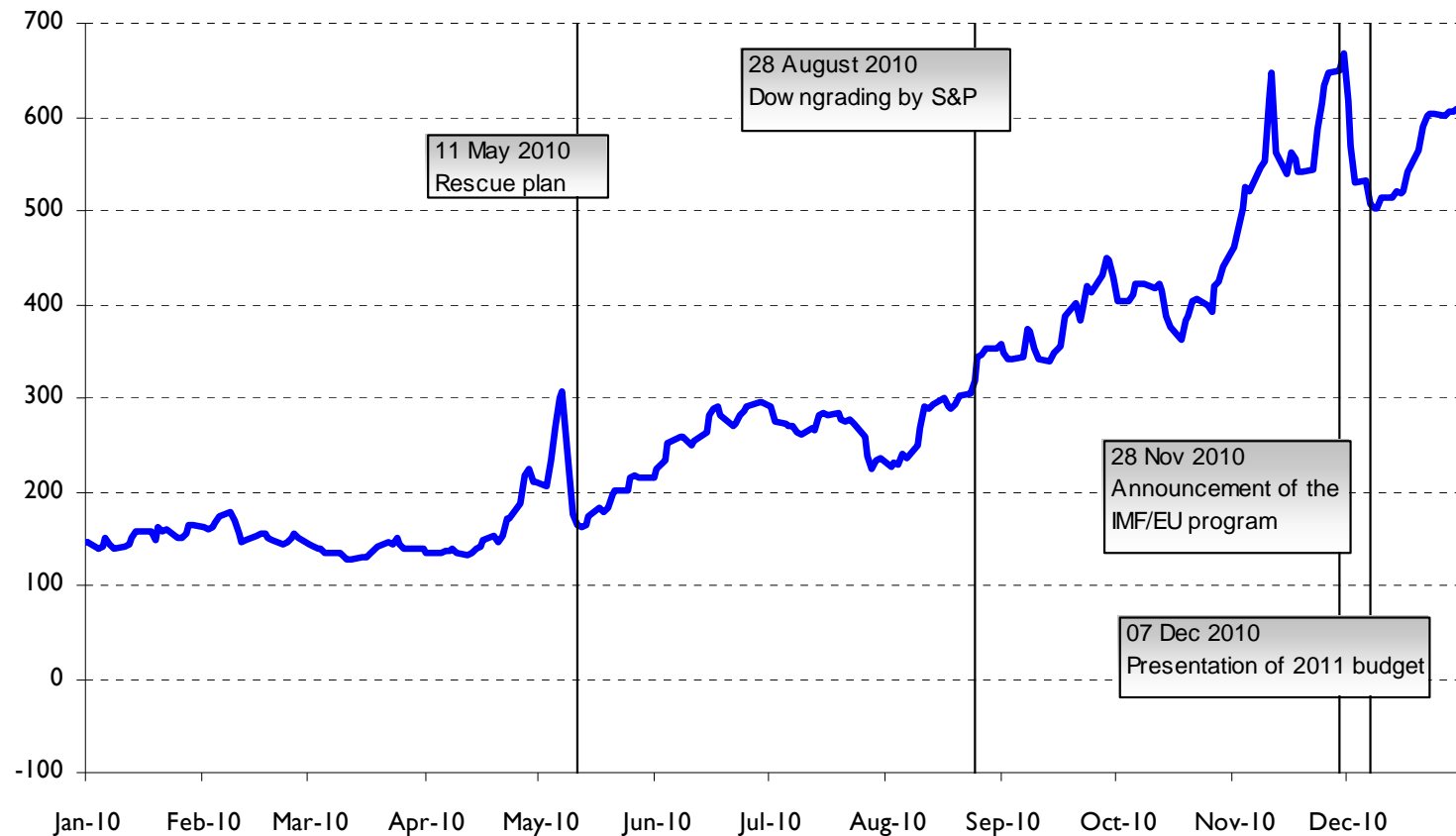


Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations.

Data: Bond yield spreads vis-à-vis the German 10-year government bond, end-of-day data.

Action has been delayed

Ireland
Spread over German 10-year government bond yield
(2010; daily data; in basis points)



Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations.

Data: Bond yield spreads vis-à-vis the German 10-year government bond, end-of-day data.

Conclusions

Plan A is painful, but most likely it is less costly than the alternative:

- for the debtor countries**
- for the creditor countries**

There are ways to make Plan A less costly, “more effective”, conditional on a positive adjustment track

Need to avoid moral hazard

Conclusions (2)

Euro area governments are committed to Plan A

Plan A will deliver stronger fundamentals over the medium term for the euro area and for the member countries