

European Macroeconomics and Governance

**Sovereign debt restructuring:
Legal frameworks and European challenges**

Workshop on 12th Feb 2015 at 11:30am. Location: Bruegel

**The Greek Public Debt:
A Progressive Solution
in a Broader European Framework**

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The Greek sovereign 'default' and the Euro area

1. The Greek sovereign 'default' unmasked the fatal weaknesses in the architecture of the Euro area (EA), after a first phase of exorbitant and unreasonable optimism.

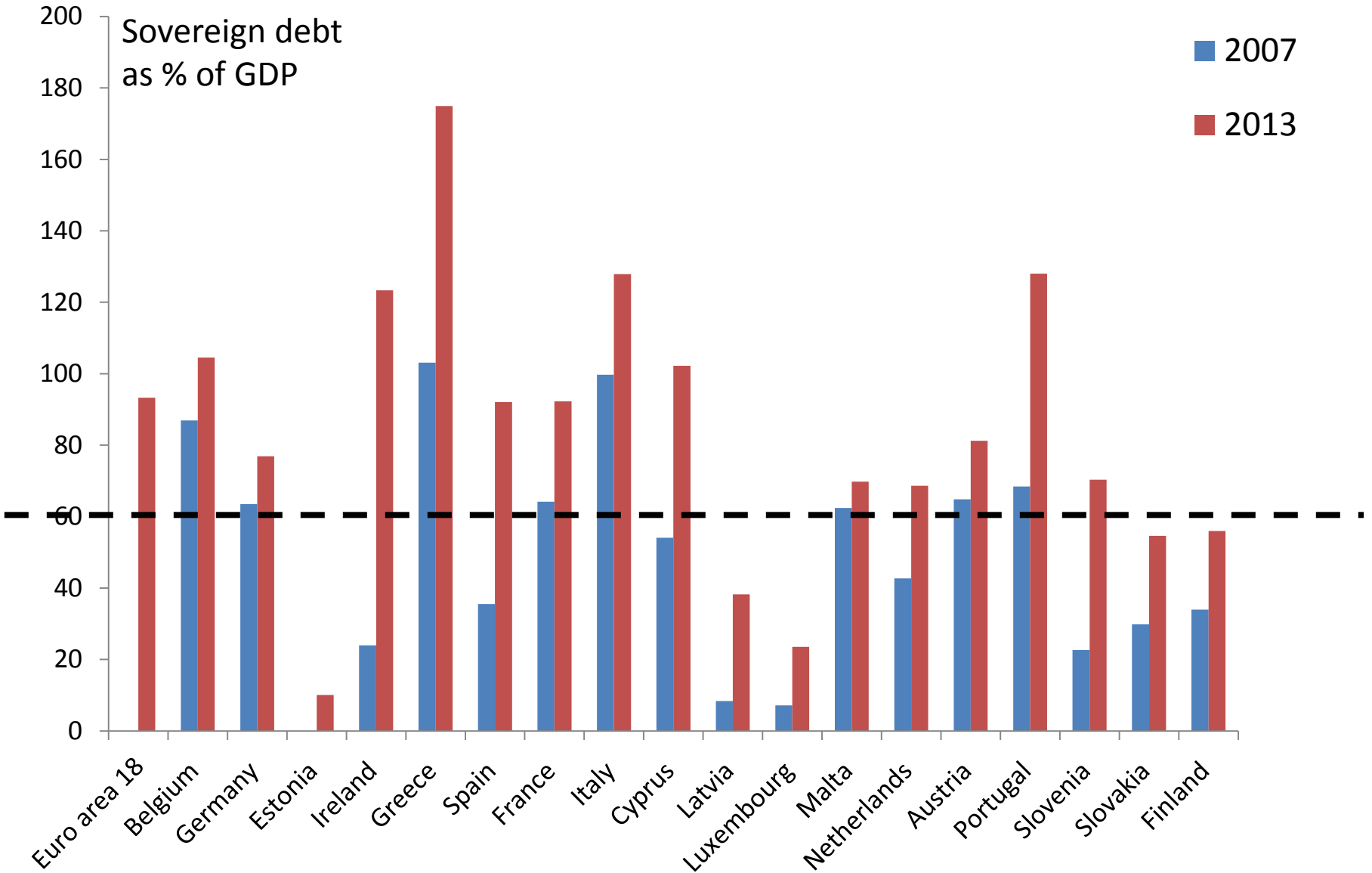
“The fundamentals of the euro area economy remain sound and the euro area economy does not suffer from major economic imbalances” (Trichet in 2008).

2. The Greek sovereign 'default' was practically the first sovereign default of a developed capitalist economy, several decades after West Germany's defaults in 1948 and 1953 in the wake of World War II. It smashed the belief that had gradually gained the status of being the norm in international economics: no one could imagine, even as a working hypothesis, a sovereign default of a developed capitalist economy and, in particular member of the EA.
3. Recession-led policies use sovereign debt as means to secure austerity strategies and further reinforce neoliberal reforms throughout Europe. Sovereign debt is a serious issue in most EA economies.

The Greek sovereign 'default' and the Euro area

4. The EA is a sui generis monetary union. It sets up a context of symbiosis that elevates default risk to secure austerity.
5. Official responses shall not block the functioning of financial markets, even during a crisis. Thus, stability of employment and incomes is subordinated to the successful functioning of financial markets. An unstable and dichotomized social regime and an increasing debt overhang seem to be the fruits of this strategy.
6. Technically, there are three alternative ways to deal with the debt problem: (i) persistent primary surpluses, which cannot be achieved in an environment of recession and contracting demand caused by austerity programs; (ii) nominal growth rates higher than implicit interest rates, which again cannot be the case in the present environment; (iii) unconventional policies and debt restructuring.

Sovereign debt overhang in the Euro area



Sovereign debt overhang in the Euro area

	real GDP % change			primary surplus		sovereign debt		effective	HCPI
				% of GDP		% of GDP		interest rate	% change
	2013	2014F	2017F	2013	2017F	2013	2017F	2013	2014F
Austria	0.4	1.7	1.4	0.2	1.0	74.2	76.1	3.5	1.6
Belgium	0.2	1.2	1.4	0.4	1.9	99.8	96.9	3.2	0.9
Finland	-1.4	0.4	1.6	-2.6	-1.9	57.0	61.9	1.8	1.4
France	0.3	1.0	1.8	-2.2	0.6	93.9	93.6	2.5	1.0
Germany	0.5	1.7	1.4	1.7	1.9	78.1	63.8	2.7	1.1
Greece	-3.9	0.6	3.5	1.5	4.5	173.8	153.7	2.4	-0.8
Ireland	-0.3	1.7	2.5	-3.4	3.0	122.8	116.8	4.0	0.6
Italy	-1.9	0.6	1.2	2.0	4.9	132.5	127.6	4.1	0.7
Netherlands	-0.8	0.8	1.8	-1.9	-0.3	74.9	73.2	2.5	0.7
Portugal	-1.4	1.2	1.8	-0.7	2.8	128.8	119.1	3.4	0.4
Spain	-1.2	0.9	1.2	-4.2	0.4	93.9	104.3	4.0	0.1



Given the current debt levels and (optimistic) macroeconomic projections, debt sustainability requires at least considerable primary surpluses in most of the EA economies.

Sovereign debt overhang in the Euro area

1. Deflationary fiscal adjustment cannot reduce a high sovereign debt.
2. Persistent primary surpluses and privatizations are definitely self-defeating strategies, NOT acceptable by the left.
3. Unconventional solutions of debt restructuring:
 - 3.1** First, every reduction in the present value of debt without a haircut of the nominal value may be a partial relief but does not strategically relax market supervision.
 - 3.2** Every significant change in the present value of sovereign liabilities cannot be a solution to the current debt overhang because it transfers the problem to the financial sector and institutional investors and, thus, back to the public budget.
 - 3.3** There is currently no political support in the EA for major fiscal transfers to tackle the problem. Given the size of the problem it would not be real solution.
 - 3.4** Traditional open market operations are a useful monetary tool and should play a more important part in ECB market interventions. Nevertheless, they cannot deal with the problem for the highly indebted states.



There is only one major and meaningful alternative left to bury austerity and kick-start growth at the EA level: a significant reduction of the nominal burden of debt in the EA economies.

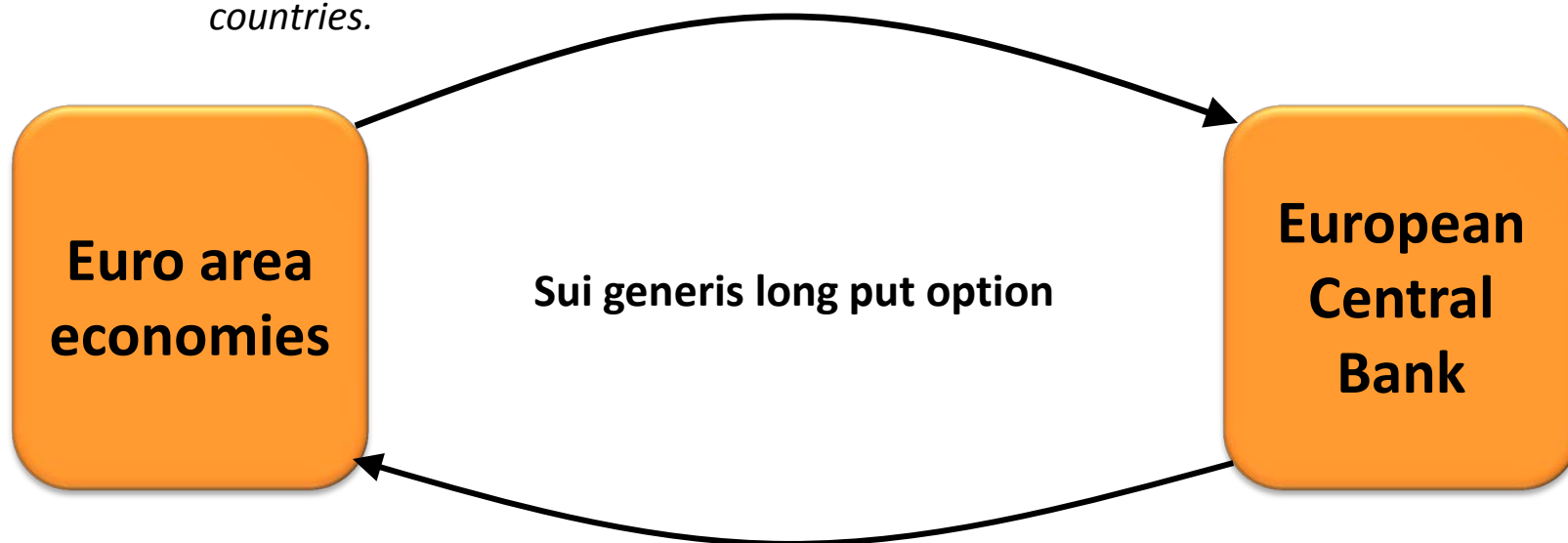
D.P. Sotiropoulos, J. Milios and S. Lapatsioras:

“An Outline of a Progressive Resolution to the Euro-area Sovereign Debt Overhang”.

Levy Economics Institute of Bard College, W.P. No 819 (www.levyinstitute.org/pubs/wp_819.pdf)

The proposal:

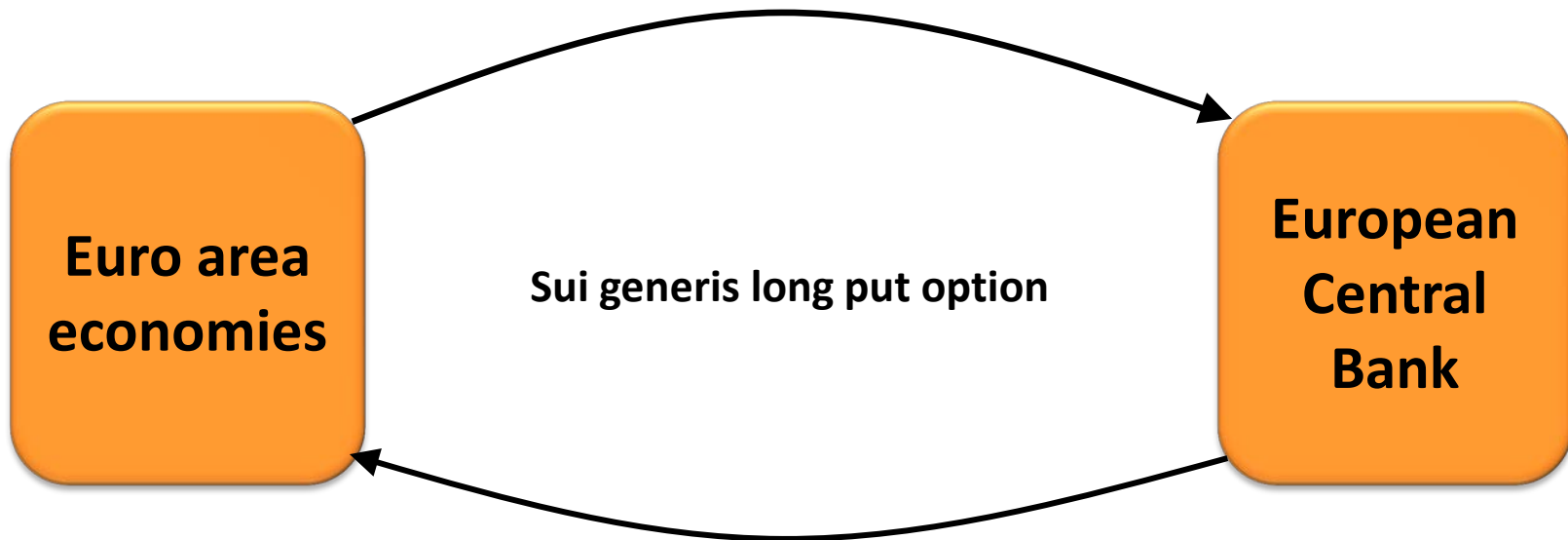
The ECB acquires and capitalizes in the form of zero-coupon bonds (i) debt maturing in the years 2016–2020 and (ii) all interest payments of the same period. In other words, the debt burden will be suspended for five years. This amounts about to 55% of the outstanding Spanish debt. To be taken as the rule for all EA countries.



Each EA country agrees to buy back from the ECB the zero-coupon bonds when their values will have been reduced to 20% of GDP, jointly accepting a (nominal) discounting rate of 1%. (In case of a restructuring of the Greek sovereign debt, the issuing of an ESM-backed GGB will be necessary).

The proposal

1. The ECB enjoys unique credibility which hinges partially upon its ability for self-recapitalization.
2. Capital gains and seigniorage profits but also sterilization costs. EA countries withdraw from seigniorage profits as long as they participate in the mechanism.
3. The overall cost of the program is lower than the ordinary actions of the ECB.
4. A rising number of mainstream economists and advisors have started talking about the elephant in the room (ECB): good timing for a proposal like this one.
5. Our proposal takes into consideration the time distribution of sovereign debt liabilities.

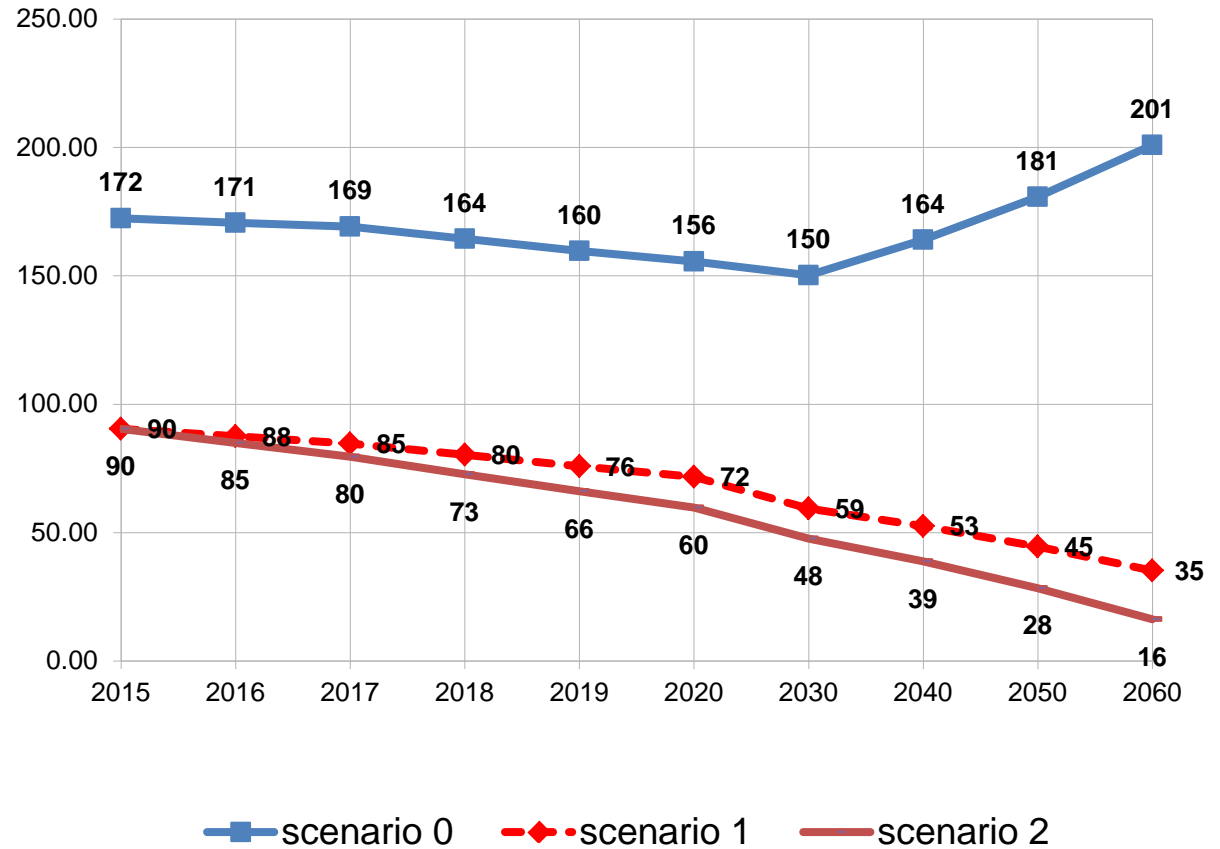


Scenario 0: austerity

Scenario 1: capitalization of debt maturing within the next five years and related interest payments

Scenario 2: capitalization of debt maturing within the next five years and all interest payments

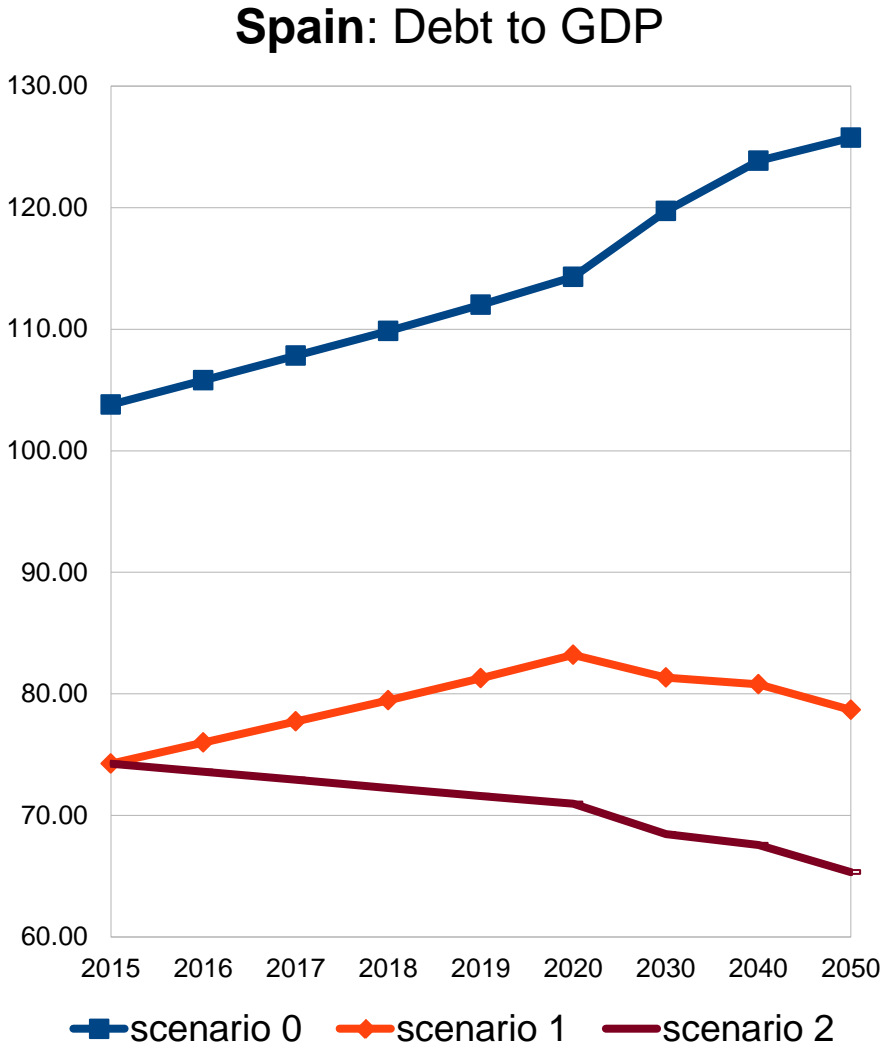
Greece: Debt to GDP



Scenario 0: austerity

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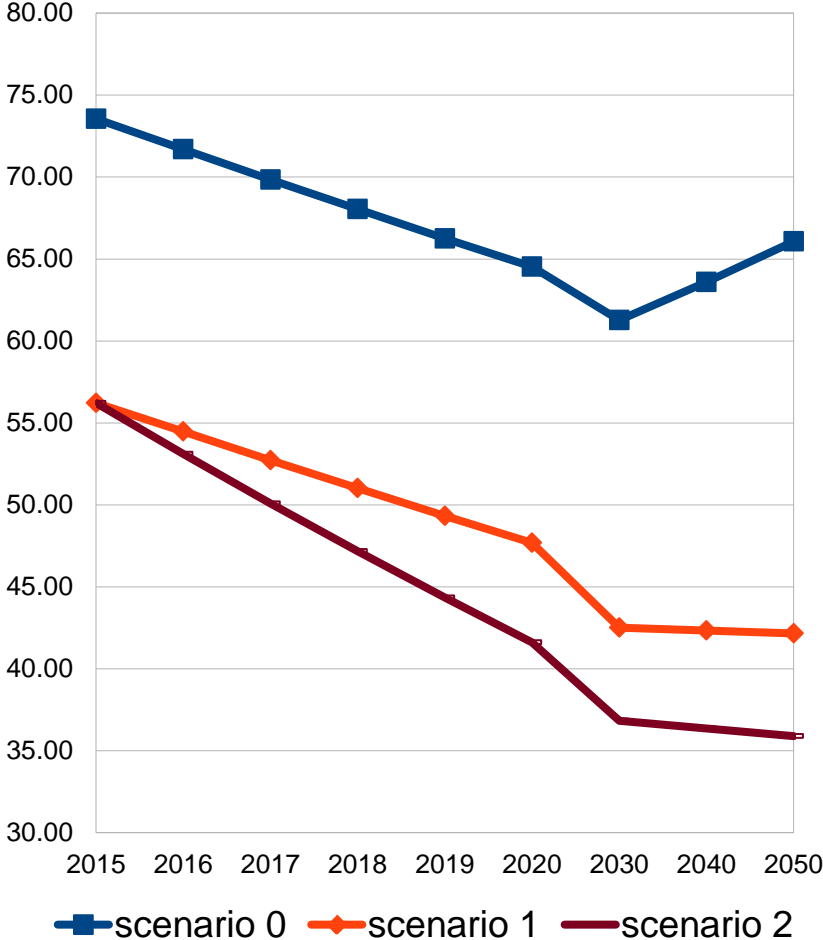


Scenario 0: austerity

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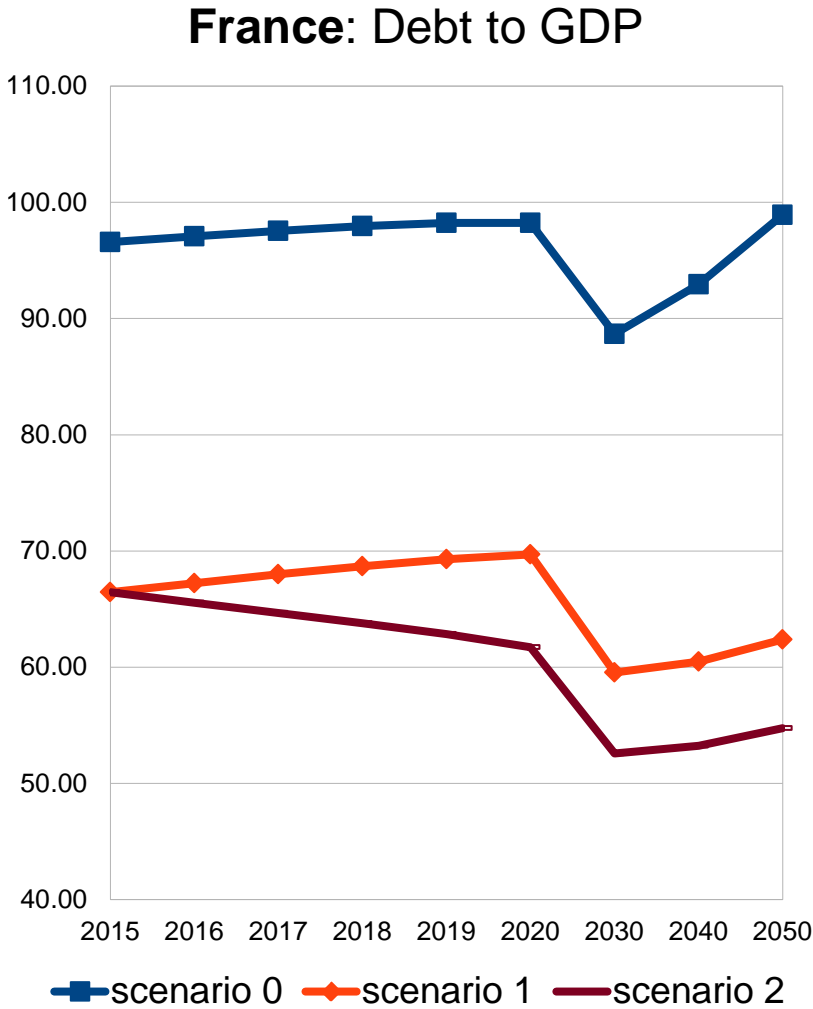
Germany: Debt to GDP



Scenario 0: austerity

Scenario 1: capitalization of debt maturing within the next five years and related interest payments

Scenario 2: capitalization of debt maturing within the next five years and all interest payments

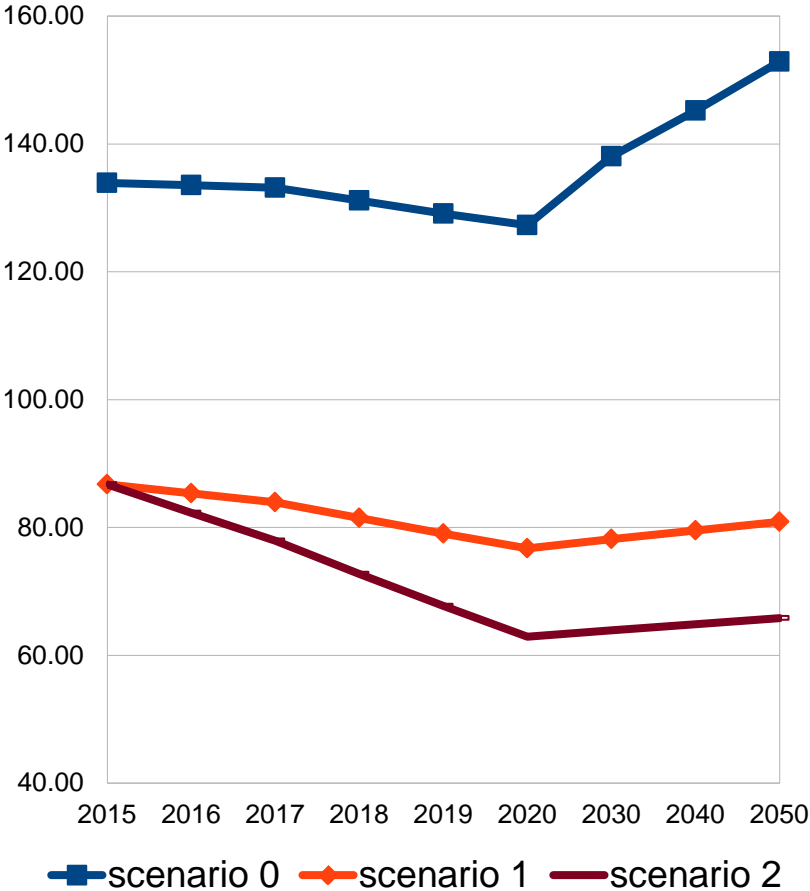


Scenario 0: austerity

Scenario 1: capitalization of debt maturing within the next five years and related interest payments

Scenario 2: capitalization of debt maturing within the next five years and all interest payments

Italy: Debt to GDP



Debt buyback time

Year of debt buyback for different EA countries in our two alternative scenarios
(when debt held by ECB becomes lower than 20% of GDP)

	Scenario 1	Scenario 2
Austria	2027	2038
Belgium	2037	2046
Estonia	<u>2016</u>	<u>2016</u>
Finland	<u>2016</u>	<u>2016</u>
France	2029	2040
Germany	<u>2016</u>	2025
Greece	2064	2069
Ireland	2052	2061
Italy	2050	2060
Netherlands	2023	2030
Portugal	2050	2057
Slovakia	2021	2028
Slovenia	2031	2042
Spain	2031	2046
EA-18	2032	2044

Sources: our calculations based on data from AMECO, OECD (2014), Ministries of Finance and Central Banks of the respective countries, and IMF. Bold letters indicate the years when the size of the debt held by the ECB is lower than 20% of the country's GDP, whereas underlined shells indicate countries with a public debt ratio lower than 20% in 2016, at the start of Agreement.