

“Sovereign debt overhangs and stabilisation policies”

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Speeches

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Ladies and gentlemen,

The crisis has taught us that one cannot think about fiscal integration, let alone a fiscal union without adequate mechanisms to avoid over-indebtedness and handle debt overhangs. We have painfully learned during the last crisis that over-indebtedness harbours instability. Therefore, I am very glad that the organisers have arranged this panel. I will talk here about the steps that Europe has taken since the crisis to address sovereign debt overhangs in euro area countries and to avoid a future build-up of over-indebtedness. I will then discuss the further need for contractual debt restructuring mechanisms. Finally, I will say something about possible models for a Europe-wide safe asset, none of which are looking viable at the moment.

The creation of the European Stability Mechanism (ESM) was only one element of Europe’s more encompassing response to the crisis. The following measures were taken to overcome the weaknesses in the euro area governance structure and to improve the resilience of the economy. First, countries reversed unsustainable fiscal and wage policies, reducing macroeconomic imbalances and enhancing

convergence within the monetary union. Secondly, economic and fiscal policy coordination at the supranational level was strengthened considerably. Thirdly, Banking Union was established to break the vicious circle between banks and sovereigns and so that investors rather than taxpayers will bear the costs of any future bank failure. These measures have made monetary union far more robust and greatly reduced the risk of a new build-up of a sovereign debt overhang of any of its members.

While only one measure among several, the establishment of the European Financial Stability Facility (EFSF) in 2010 and the permanent European Stability Mechanism two years later were crucial because there was no lender of last resort to sovereigns in the euro area before the crisis. These two backstops successfully contained the crisis and prevented contagion. The ESM will continue to provide this function should there be any sovereign liquidity crises in the future.

The ESM approach to crisis resolution entails a number of important elements to address a sovereign debt overhang. First, the ESM provides financial assistance under strict policy conditionality. Money is only disbursed if countries implement policy reforms to tackle underlying weaknesses and imbalances. Fiscal adjustment is always an important priority, and this has led to the disappearance of fiscal imbalances in each of the five programme countries.

Secondly, the financial assistance of the ESM has had another important effect on beneficiary member states through its long maturity and affordable loans. This helped reduce the impact of the debt overhang on growth. The savings coming from the reduced interest rate bill on ESM loans amount to several percent of GDP. The protracted repayment profile of our loans effectively reduces refinancing needs (and roll-over risks), paving the way for a smoother re-entry into market financing. This increased the fiscal space in beneficiary countries frees up funds that could be spent on other purposes, including investment.

Finally, the ESM is meant to provide financial assistance for countries with sustainable debt. If this is not the case, countries need to seek participation of the private sector in reducing liabilities. This happened in Greece and Cyprus. Greece conducted the biggest debt restructuring of an advanced economy in modern economic history. At over €200 billion, it dwarfed the largest previous debt restructuring, the €73 billion Argentina defaulted on at the start of the century. The

haircut, on average, was 51%[\[1\]](#). In Cyprus, the private sector had to participate in the repair of the banking sector. Otherwise, the sovereign would have been overburdened.

The Economic and Monetary Union is on a much stronger footing because of this comprehensive policy approach. Its institutions are more complete, its macroeconomic policies sounder, and its economy is staging a recovery that is now in its fifth year. Of course, further improvements remain possible. Investors sometimes question what assurances they have that countries will stick to the fiscal rules. It is true that the current set of fiscal rules is very complex – too complex to be intuitively understood and easy to communicate. This clearly weakens their effectiveness.

Proposals are therefore made to move away from a rules-based approach to ensure fiscal prudence and strengthen market discipline instead. This means that risk needs to be priced properly. Investors should know that the cost of default will not be borne by society, but that there will be an effective debt restructuring in which they can lose money.

Euro area countries have already gone further than others in establishing contractual arrangements facilitating debt restructuring. This is achieved through the so-called common collective action clauses in bond documentation. These mechanisms should help to address sustainability issues in case financial assistance is needed.

I share the view that further measures should be taken to strengthen market discipline, but they must be well-structured to work. A number of recent proposals call for the installation of procedures such as automatic maturity extension in case a country requests official lending support. It is my view, however, that determining when a debt restructuring is necessary requires more than setting one-size-fits-all automatic thresholds on debt features or policy actions.

Debt reprofiling can have very negative and lasting economic implications. Any system that uses them should do so only when necessary. A mechanistic rule could have the further negative effect of destabilising pro-cyclical effects on the ailing country's financing conditions. A country seen as approaching restructuring would

likely have investors withdrawing from its bonds. I believe that a further improvement to the collective action clauses – as a contractual approach – would have smaller negative implications for market sentiment and could politically be more palatable.

It is important to underscore that market discipline cannot work on its own and that, in my view, it continues to presuppose an effective and credible European fiscal framework. Market discipline has its limitations, and often only allows two flavours: risk-on or risk off. Therefore, there is no guarantee that markets always have the desirable disciplining effect. When they wake up, it may be too late. The market isn't always right – herding behaviour and irrational overreactions show that.

Finally, let me say something about the creation of a European-wide safe asset, or risk-free asset. Creating a common European “safe asset” would, in principle, be another step to enhance the resilience of the euro area economy and promote financial integration.

Different models for creating a safe asset have been debated. The ambition of these models goes far beyond the current issuance activities of highly creditworthy European institutions. The common characteristic is to create a European fixed-income instrument with ample liquidity, comparable to that of the US Treasury market. A Eurobond guaranteed jointly and severally by euro area member states is a type of safe asset at one extreme of the range of models that have been proposed. However, this would imply the mutualisation of debt. The fundamentals in euro area countries are currently not strong enough to avoid the risk that disproportionate support by euro area sovereigns could be needed. Eurobonds are therefore not an option at the moment.

Financial structures avoiding such mutualisation are therefore also discussed, entailing the tranching of bonds and securitisation. One option is to tranche national bonds at different subordination levels depending on sovereign risk of each country of origin. Another proposal that has gained a lot of attention is to introduce securities backed by a portfolio of European sovereign bonds, where the senior tranche would represent a synthetic Eurobond. But while a synthetic Eurobond or national tranching could bring about some benefits, they also require further coordination and there are doubts whether they can address flight to safety and help stabilise the Eurozone in stressed times.

First, introduction of these assets would reduce the depth and liquidity in national bond markets. This is a high price to pay for sovereigns, particularly taking into account that the market characteristics of the new assets are still uncertain. Moreover, they would require a harmonisation of the bond terms across countries. Otherwise, it will not be possible to create a common liquid market. Therefore, a tranching approach can only work if there is first a consensus on the rules to handle debt overhang and restructuring.

Second, the dynamics of flight to safety would be transformed only to some extent, depending primarily on what share of sovereign debt would be financed by means of these securities, on the strength of the shocks and whether the crisis is systemic or limited to one country. None of the proposals can exclude destabilizing flows from more risky to safer sovereigns as long as national bond markets exist. For bigger or systemic shocks, even the senior tranches of vulnerable sovereigns or the synthetic Eurobond could come under pressure.

Finally, independently of the strength of the shock, in times of stress, the debt management agencies in riskier countries and the issuer of synthetic Eurobonds would have difficulties finding investors for the junior tranches. This would drive up financing costs and limit overall issuance including that of safe tranches. The issuer of sovereign-backed securities would therefore not be able to support the stressed sovereign by increasing demand in bad times, given that mutualisation is ruled out.

In times of economic stress, countries would still have trouble finding investors. This is both due to reduced depth of the market and the high risk of the junior tranche. At the time when it is most needed, issuance of the safe asset would also be reduced. To my mind, an example of a safe asset that does exactly the opposite are ESM and EFSF bonds, which are safe bonds, issued in bad times to support a risky sovereign that needs to issue more than markets can take.

Therefore, the conditions for the introduction of safe assets are not in place and the specifics of how to introduce and develop a market for euro area safe assets requires more thought.

Let me conclude. We want a functioning and more resilient monetary union. We have learned a lot from the crisis and improved the institutional infrastructure of the euro area significantly in handling debt overhangs and safeguarding financial stability. The next steps to improve the architecture of the euro area will require the

right balance of risk sharing and risk reduction. This requires first and foremost a consensus how to ensure fiscal discipline and handle debt overhangs. Private sector risk sharing through financial integration can complement this process.

Creating a European safe asset in bond markets in theory has many benefits, but debt mutualisation at the moment is not economically advisable nor politically achievable and therefore this is not an option at the moment. It remains to be seen whether other models, including tranching and securitization approaches, can be a success. While they could bring about some benefits, it is not clear that they have the properties to safeguard financial stability.

[1] Jeromin Zettelmeyer & Christoph Trebesch & Mitu Gulati, 2013. "[The Greek debt restructuring: an autopsy](#)," [Economic Policy](#), CEPR;CES;MSH, vol. 28(75), pages 513-563, 07.

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