Speech by Rolf Strauch at Debtcon sovereign debt research conference

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Rolf Strauch, ESM Chief Economist
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Should the private sector bear the costs of investment decisions made in the past if a country fails to honour its debt? To what degree should public money shield the private sector? This is the important issue this panel raises. In other words, we will try to find the right balance between what is known as bail-out and bail-in.

In looking for answers, there are some lessons to be learned from the European debt crisis. Operating inside a monetary union – such as the euro area - adds another layer of complexity. Here, one government that does not honour its debt obligations can cause problems for neighbouring countries, as the crisis has shown.

The euro area did not have the right tools to deal with a sovereign debt crisis in 2009. It had simply been deemed impossible that a country could lose market access, risking default, once it had become a member of the monetary union. And yet that is exactly what happened. Since then, Europe has made enormous progress in finding the right balance between bail-out and bail-in.

Europe’s responses consisted of the three different types of adjustment that are normally available to cope with a sovereign debt overhang: domestic policy adjustments, official sector support and debt restructuring. Let me say a few words on each of them.

Domestic policy adjustments had an institutional component and a macroeconomic component. On the institutional component, Europe has tightened the fiscal rules of the Stability and Growth Pact. This reduced euro area budget deficits across the board, and in the aggregate. Unfortunately, the rules have now become too complex and are hard to understand, even for experts. So it is good that a debate about how to simplify them has started.

The macroeconomic component consisted of structural reforms and fiscal adjustment. Countries have done their homework since the crisis, particularly ESM programme countries. All of them are reform champions, according to the OECD and World Bank.

The second euro area crisis response consisted of official sector support. This is the area where the most significant progress was made. There was no lender of last resort for sovereigns in the European Monetary Union before the crisis. Today, Europe has adopted the IMF approach of providing financial assistance to a country on the condition that it implements reforms. This method has been tried and tested by the IMF for many decades.

Contrary to doubts expressed early on, the recipe also worked in Europe, and imbalances have now been corrected. It is true that the severity of the European crisis necessitated large-scale financial support. The EFSF and ESM loan packages to Greece are by far the largest the world has ever seen, and the two institutions now hold 50 percent of Greek public sector debt. The ESM provides loans at extremely favourable conditions, with long maturities and very low rates, because of our strong credit rating. Our lending rates are only a third of what the IMF charges. This leads to very substantial budget savings for programme countries, and makes refinancing needs manageable. Already, four out of the five programme countries have succesfully returned to the financial market. Greece can do the same, if it sticks to implementing the reforms it has promised.

Thirdly, debt restructuring. I just made clear that Europe’s financial assistance programmes entailed a substantive bail-out element, because they assumed private sector risk. But, similar to the IMF, there was also an element of bail-in, when a country’s public finances were still deemed unsustainable after receiving support, or if rescuing the banking sector would have overburdened the sovereign. This is what eventually happened in Greece and Cyprus.

Holding the private sector accountable for past decisions has also been part of other policy responses. Europe has gone further in introducing Collective Action Clauses in debt contracts than other regions. We could look to strengthen through aggregation clauses, to limit the risk that hold-outs undermine a debt restructuring. But already, the fact that CACs are now part of standard bond prospectuses will greatly facilitate future debt restructurings.

It was even more important to break the vicious circle of between banks and sovereign debt. The creation of Banking Union was an important step to achieve this. The Single Supervisory Mechanism and the Single Resolution Board are the two main pillars of Banking Union. New rules for bank resolution are firmly based on the bail-in principle. Finally, a quick word on efforts to facilitate debt restructurings, and to further reduce the need to bail out the private sector. A number of proposals – contractual and statutory, including a Sovereign Debt Restructuring Mechanism - exist.

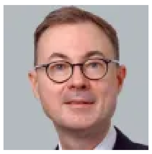
In our view, it is worthwhile considering ways to make restructurings more manageable and make efficient use of ESM resources. However, we should avoid automatic debt restructurings, which could cause the market to shut out any given country. This could lead to unnecessary costs for the country and the euro area. Debt restructurings are a long-standing practice of the Paris Club, supported by the IMF. They are dealt with on a case by case basis, and this is for good reasons. A contractual approach – with further adjustments of CACs – therefore appears as the best way forward, possibly combined with the creation of an arbitration body.

Author

Rolf Strauch

Chief Economist and Management Board Member

Contacts

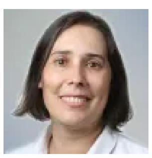


Cédric Crelo

Head of Communications and Chief Spokesperson

+352 260 962 205

c.crelo@esm.europa.eu

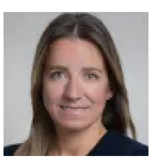


Anabela Reis

Deputy Head of Communications and Deputy Chief Spokesperson

+352 260 962 551

a.reis@esm.europa.eu



Juliana Dahl

Principal Speechwriter and Principal Spokesperson

+352 260 962 654

j.dahl@esm.europa.eu