Managing debt sustainability and safe assets in the euro area - speech by Rolf Strauch

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Ladies and gentlemen,

Crises often lead to progress. During such periods, people realise they need to fix the underlying problems that are exposed. The euro debt crisis likewise has taught us many lessons. I will discuss what we learned in the fields of debt sustainability and risk-free assets. What has changed in our analysis of these two topics? What have we learned in how to deal with a debt overhang? How can better debt sustainability and a safe asset for the euro area help to limit the impact of the next crisis?

My remarks will focus on three issues. First I will talk about how to better prevent a debt overhang. Then I will touch upon what we can do if a country's debt burden is unsustainable. The crisis has shown that it is needed to address a country's debt overhang for it to regain its footing, and be able to attract investors again. Finally, I will say a few words about a safe asset for the euro area. This topic has been debated for a considerable amount of time. In theory, everybody agrees that a safe asset would help improve the financial resilience of the euro area. But it is not clear to me at the moment that we better understand how to set one up in practice.

Let me first talk about how to better prevent a debt overhang. A loss of competitiveness was a crucial factor during the euro debt crisis, when five countries lost, or nearly lost market access. It caused current account imbalances, which needed to be dealt with during the ESM reform programmes. Fiscal imbalances were the other major driver of the sovereign debt crisis. Greece had racked up a budget deficit of 15 percent, which it had tried to hide by reporting incorrect numbers. Several countries were also burdened down by very high debt-to-GDP ratios. A high debt stock does not inevitably mean that a country loses investor confidence, but it is certainly a major factor. Moreover, a debt overhang always means less fiscal space for countercyclical measures, and for investments in infrastructure. This holds back potential and actual growth rates.

Sticking to the rules is the most obvious way to prevent a debt overhang. The fiscal framework in the European Union has been laid down in the Stability and Growth Pact, and the Maastricht Treaty. I cannot underscore enough how important it is that countries stick to this underlying principle of EMU. Since the framework has become very complex during the crisis, making fiscal rules simpler and more understandable again would increase their effectiveness. That is one of the elements to be taken up for the discussion on the further deepening of EMU.

Another important way to prevent debt overhangs is to cut the close ties between governments and national banking systems, a relationship that has been called the sovereign-bank feedback loop. This stranglehold forces governments to rescue their banking systems during a crisis. They need to do so to protect creditors by preventing bank runs. But such support is always needed at a time that governments can least afford it, during a crisis. This then puts pressure on the value of sovereign bonds, which the banks have invested in heavily. And so a downward spiral opens up.

Europe has made great strides in severing this knot between banks and governments, by setting up the Banking Union. Banking supervision and resolution, formerly national competences, have now been transferred to the central level. The successful resolution of Banco Popular in Spain has shown that the system can work also under extreme time pressure. But Banking Union remains incomplete as long as Europe does not have a strong financial backing in this area – and that means a fully-fledged common backstop for bank resolution and a common deposit insurance.

At the moment, this is a difficult discussion in the euro area. Remaining risks in the banking system will need to be reduced further first. Banks are much better capitalised than during the crisis, but profitability remains low. One reason are the stocks of non-performing loans, which remain too high, even a decade after the crisis in some countries. These legacy assets require funding by liabilities that could otherwise be used for loans to companies to foster growth. In other words, much repair work was done but this process needs to continue to fully cut the sovereign-bank feedback loop. A healthier banking system would have the additional benefit of allowing greater risk-sharing through the private sector, which would further increase the resilience of the euro area.

A central fiscal stabilisation tool would be a further way to prevent a build-up of debt overhangs. It would allow a country to get temporary support to cope with an economic shock. The arguments for such a euro area facility are sound, but the political discussions about it will require time. A central fiscal capacity could only work if it does not lead to permanent transfers and broad based debt mutualisation.

Let me now turn to the second issue: how to deal with a debt overhang, and how to achieve that debt returns to being sustainable. The ESM provided support to five countries. A debt sustainability analysis is a necessary input in designing euro area assistance programmes. The ESM Treaty tasks the European Commission with assessing whether public debt in a country is sustainable. In the future we hope that this will be done jointly with the European Commission under a strengthened mandate of the ESM. We also learned much from the experience of the IMF. Lending by the Fund is always conditional on debt in a country being sustainable.

Fiscal adjustment played a role in achieving debt sustainability in each of these programmes. I already mentioned the very large budget deficit in Greece in 2009. Since 2016, it has consistently posted a small budget surplus. Needless to say, this meant imposing hardships on the population. Public sector employment was reduced by 25 percent. Greece is only one example, but others are similar. Fiscal adjustment is inevitable in order to achieve debt sustainability in every case.

Granted that a country is doing enough to return to sustainable debt dynamics, official sector lending can be an important additional factor in addressing a debt overhang. The ESM provides lending at very favourable conditions. In the first place, we provide loans at a very low rate. We directly pass through our own cost of funding, which, in the case of the ESM is just one percent at this stage.

Moreover, the terms of ESM loans are more flexible than those of the IMF and can be adjusted to the country needs. Our loans provided during the crisis have longer maturities and in the case of Greece long interest rate deferrals. Moreover, we charge a substantively lower interest rate margin than the IMF does for sizeable lending. Our lending terms have led to substantial budget savings for countries. In the case of Greece, we estimate that this amounts to around €12 billion each year, or around 6.7 percent of GDP. This substantial support buys a country time to get its house in order and helps it to regain the trust of investors. It is a clear sign of solidarity between euro area countries.

If the debt of the sovereign is judged unsustainable despite programme efforts, a debt restructuring may be inevitable before financial assistance is granted. A number of recent academic proposals argue that the euro area could benefit from a mechanism to facilitate the restructuring of sovereign debt with private creditors. Several proponents ask for automatic debt restructuring. We think this is not a suitable way forward as such an approach may actually drive a country into a crisis situation. We think the framework to analyse debt sustainability, and how to negotiate the contribution of the private sector in rescuing a country could help to make negotiations with private sector creditors more predictable and transparent. That should not make debt restructuring involving the private sector more frequent but help to avoid delays in decision-making and thereby reduce the costs. The past experience has shown that acting with delay tends to increase substantially programme costs. The ESM could play a role in this process in assessing the debt sustainability of a country jointly with the European Commission and in facilitating the negotiations.

Work is also ongoing to make it easier to reach decisions by private creditors. This can be done to improve the contractual arrangements that are part of bond documentation. The goal is to reduce the power of so-called hold-outs, who are in possession of only a small fraction of a country's debt, with which they can block a majority decision. This is done by reforming so-called Collective Action Clauses, or CACs. The industry itself has made reform proposal by moving to what is known as a single-limb aggregation model. Under single-limb aggregation, the fate of a certain series of bonds is no longer completely in the hands of its own holders. It becomes possible for a series to be restructured, even if all holders of that series vote against it – provided that the proposal obtains the needed majority across all voting series combined. This improves the chances of a restructuring being approved in two ways. Either directly, by increasing the amount of bonds that a reluctant bondholder needs to form a blocking minority. Or indirectly, as bondholders are more likely to vote in favour of an issuer's proposal if they know it is likely to succeed.

Let me now turn to my third topic: a risk-free asset. There is consensus that a safe asset would be a major step forward for Europe. It would support private risk-sharing, and tackle euro area financial fragmentation. It would fit well into the Capital Markets Union, and would contribute to lowering risks on the balance sheets of banks.

Intuitively, such a safe asset could take the form of jointly issued Eurobonds. This, however, is a distant dream. There is no political backing for debt mutualisation among the countries of the euro area. This is because of a lack of confidence that macro-economic rules will be strictly followed by all countries. More importantly, there are still some structural differences across countries in terms of existing debt stock and private sector liabilities as well as expected growth rates. Given that background, the euro area does not seem to be ready yet for Eurobonds.

There have been several proposals for safe assets using financial structures that avoid debt mutualisation, such as sovereign bond-backed securities (SBBS). These entail securitisation techniques creating senior and subordinated tranches, backed by a pool of sovereign bonds. In my view, it is doubtful that these would attract sufficient investor demand to create a meaningful deep and liquid market. Particularly, it is not clear whether investor demand would be available for the riskier part of these instruments during stress periods. Nor might they solve the flight to safety problem that occurs during a crisis and investors could still flee into the safest bonds of a euro area member state.

I would therefore recommend that we continue to think about different ways to create a safe asset for the euro area, as long as the conditions for issuing jointly guaranteed debt aren't there. Bonds issued by the ESM at least show that papers backed by all euro area countries can be successfully issued in size to the market. ESM bonds enable investors exposure to euro area credit which they would otherwise have to construct by buying a basket of bonds from these 19 issuers.

Let me stop here. I talked about three ways to prevent the build-up of a debt overhang: sticking to the fiscal rules, cutting the sovereign-bank feedback loop, and setting up a central fiscal stabilisation tool for the euro area. I then discussed what can be done to render a country's debt sustainable: fiscal adjustment, official sector lending and debt restructuring. In this light, work is continuing to improve CACs. Thirdly, I spoke about a safe asset for the euro area. We all agree that this would be a valuable addition to achieve greater resilience. But given the remaining structural dispersion and a lack of political consensus, its implementation is probably still a while away.

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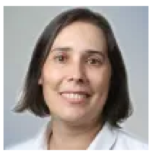

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