

# Sovereign debt in Europe: Are defaults inevitable?

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# Outline

- Answer to the question in the title: Yes
- Unless shift in behavior of ECB
- The real fault of the Euro area is the bad design of the ECB, ill suited to deal with crisis episodes
- Inter-linkages between sovereign debt and bank balance sheets at the heart of the problem
- Need to distinguish normal times to moment of crises

# A world of debt: public and private

Table 1  
Debt securities outstanding<sup>1</sup>

In billions of US dollars

	Dec 89	Dec 99	Dec 06	Dec 09	Sep 10
<b>Governments</b>	<b>7,201</b>	<b>14,401</b>	<b>25,445</b>	<b>36,356</b>	<b>40,303</b>
United States	2,839	4,408	6,236	9,486	10,758
Japan	1,306	3,670	6,750	9,657	11,215
Germany	250	622	1,479	1,850	1,863
Other euro area	1,474	2,831	4,796	6,654	6,726
United Kingdom	226	473	841	1,239	1,434
<b>Financial institutions</b>	<b>5,873</b>	<b>15,555</b>	<b>34,556</b>	<b>44,003</b>	<b>42,803</b>
United States	2,656	7,979	16,013	17,464	16,410
Japan	928	1,662	1,079	1,204	1,337
Germany	482	1,531	2,399	2,649	2,436
Other euro area	959	1,903	7,621	12,017	11,774
United Kingdom	151	712	2,605	3,762	3,731

<sup>1</sup> Domestic plus international.

Note: The BIS endeavours to eliminate any overlap between its international and domestic debt securities statistics as far as possible. However, as two different collection systems are used (security by security collection system for IDS and collection of aggregated data for DDS) as well as two different approaches and definitions (market definitions for the IDS and statistical definitions in the DDS), some overlap and inconsistencies might remain by a margin which differs from country to country.

Source: Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; national authorities; BIS.

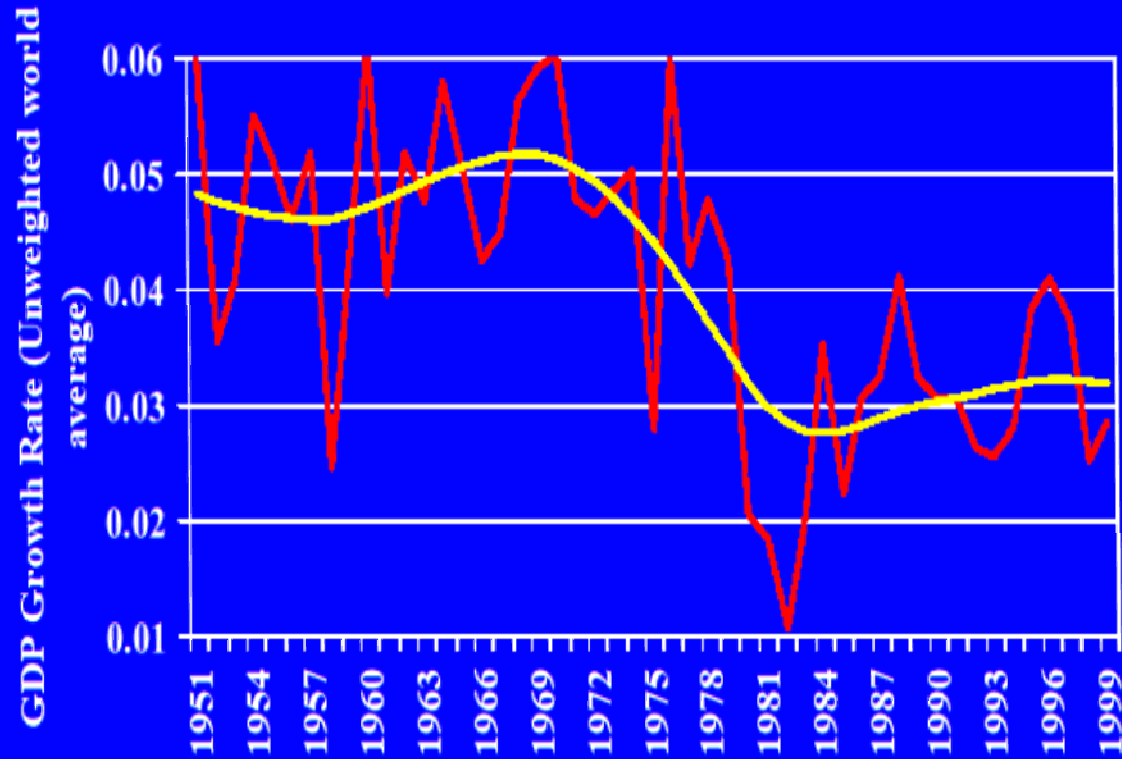
# Sovereign debt and banks: An explosive mix

- The real problem is the interlinkage between sovereign and the banking sector in the Euro zone
- Other factors are important but this is the key in the Euro zone and the main weakness of the system
- Political union useful but not necessary if policy makers had thought about the design of an integrated financial sector and the need of a Lender of Last Resort

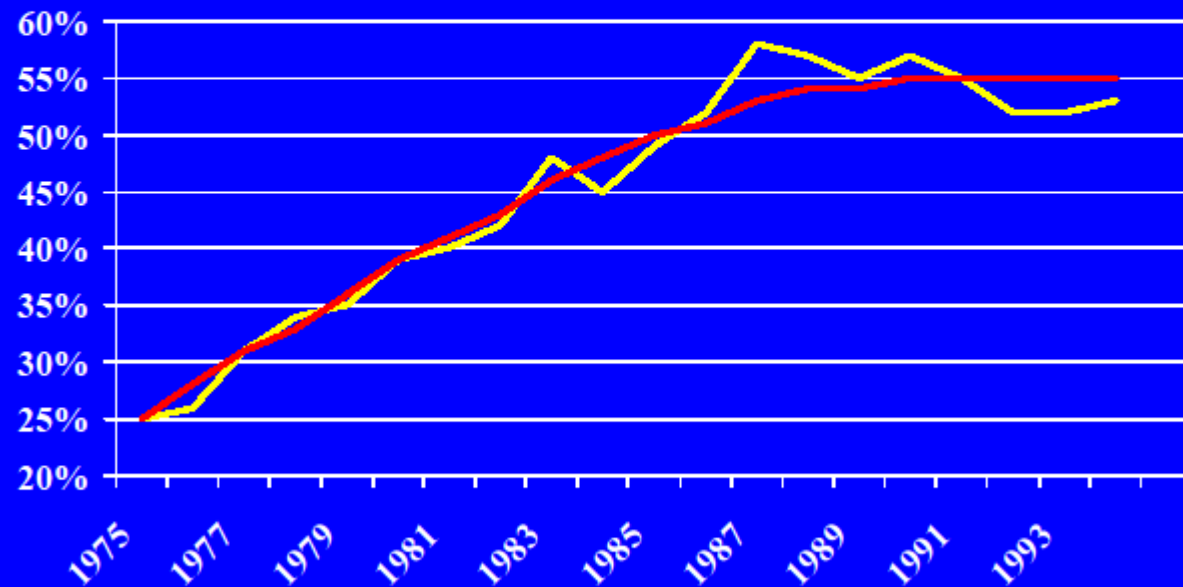
# The tyranny of asymmetry

- Recessions, and even growth decelerations, lead to public debt explosions
- However, high debt almost never solved by “growing out of it”
- Recovery not a viable solution to debt adjustment

# Growth Implosion: The World Growth Slowdown



## Debt explosion: the rise in public debt to GDP ratios (world average)



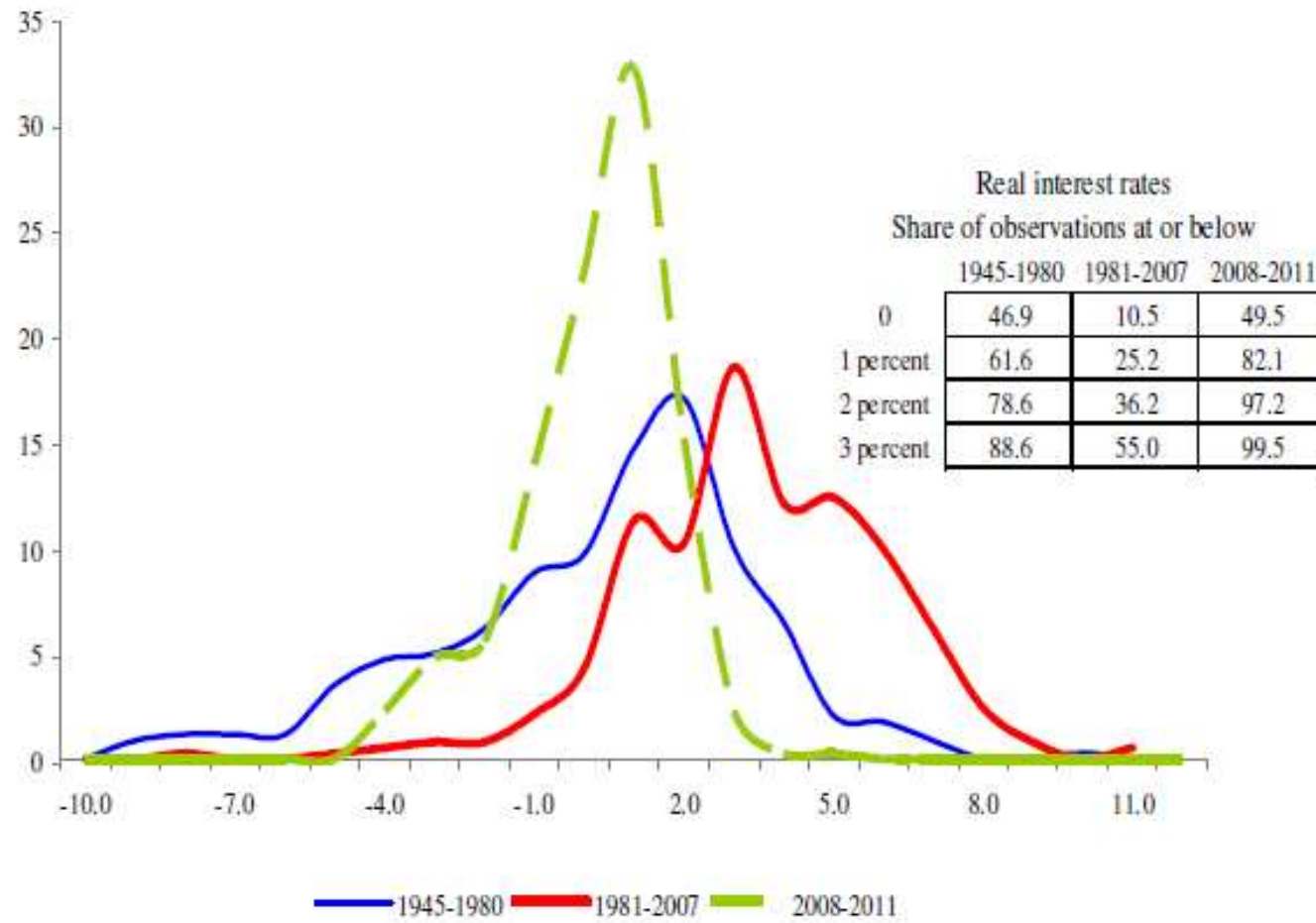
# If it is not growth, what?

- Most likely scenario: Negative real interest rates, thus “hidden confiscation”
- However, for some countries restructuring of debt (de facto default) inevitable (in addition to Greece, Portugal, Ireland, Italy (?))
- Indeed, erosion via inflation too slow for them



# Return to negative real rates

Figure 1: Real Interest Rates Frequency Distributions: Advanced Economies, 1945-2011  
*Treasury bill rates*



# Short-run

- EFSF: unlikely to solve the problem
- Too small, too politicized
- If leveraged, adds debt to existing debt...cannot be the solution
- It may help if contagion limited (thus leaves Italy, Spain (France?) untouched)
- But this is not the case

# Contagion: Liquidity at center stage

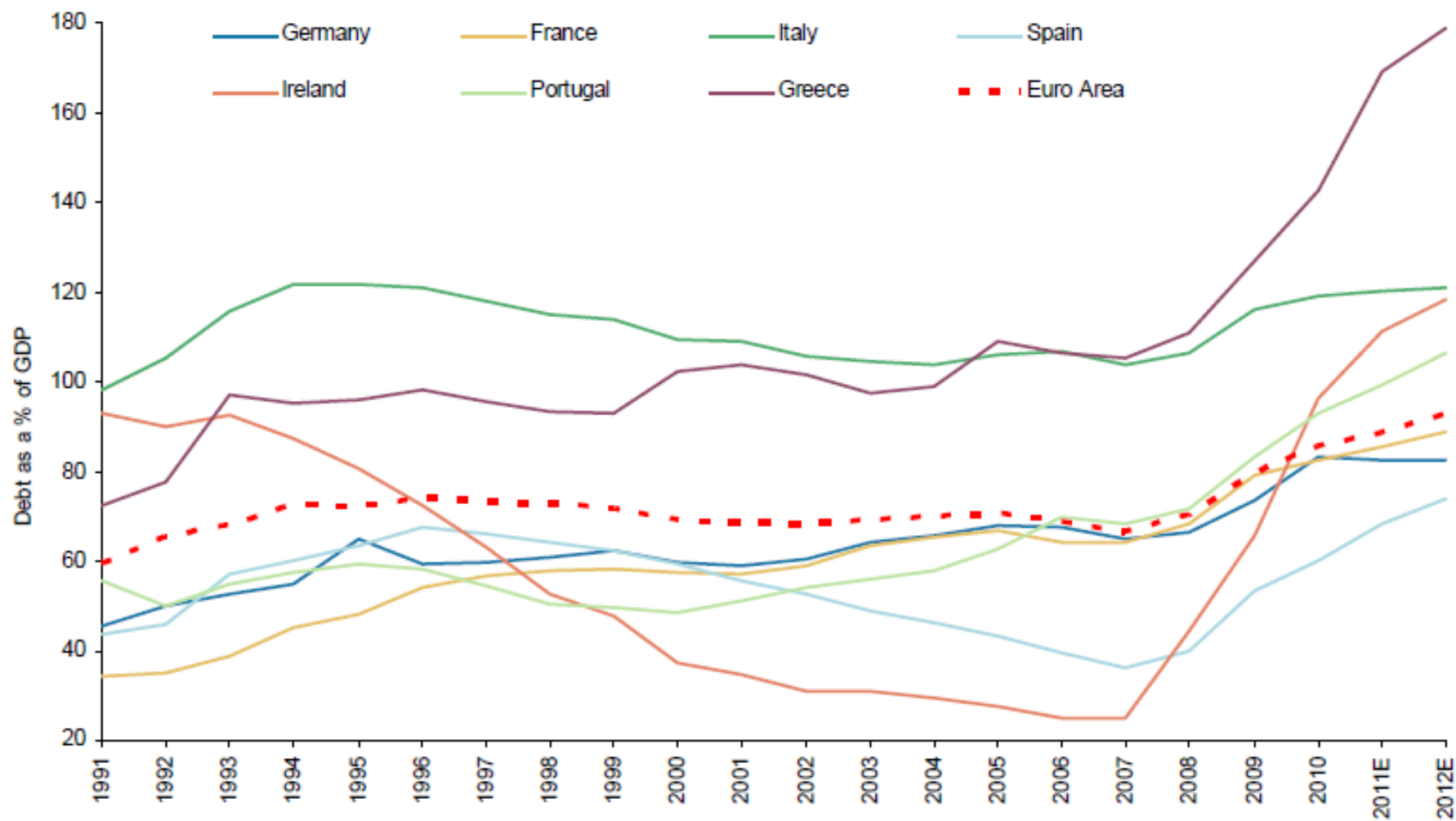
- Post 2007 dynamics: Greece, Portugal and Ireland sharp acceleration
- Italy, small increase, in line with Euro zone
- Look as well at debt/revenue
- Increase in Italy among the smaller in Euro zone
- Contagion

# Multiple equilibria

- When debt high countries expose to self-fulfilling prophecies
- If expectations become pessimistic default becomes inevitable
- In the Euro area such process was lead by contagion
- Inability to give clear signals on solution of the Greek (Portuguese and Irish) problem

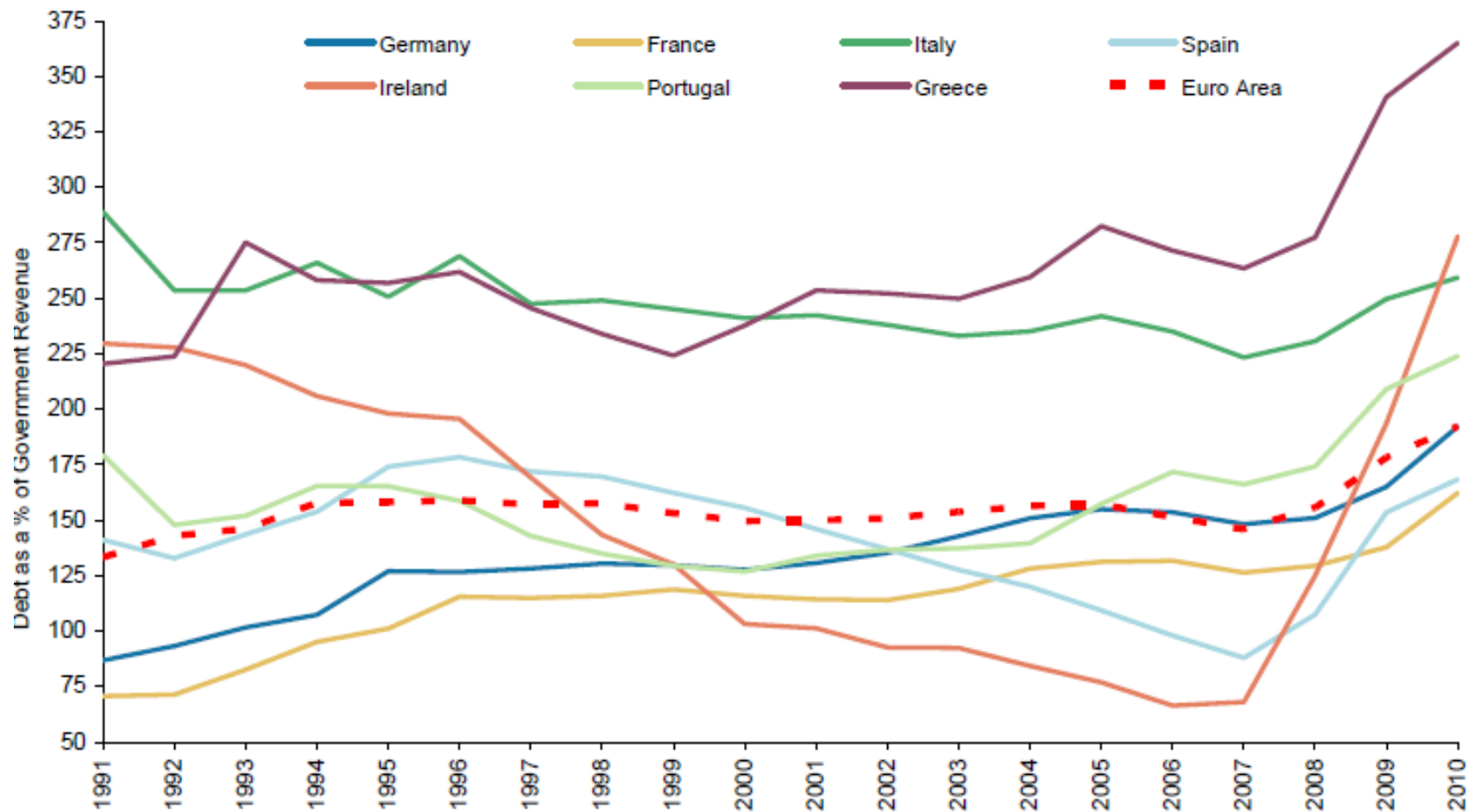
## Debt Level

### Gross Government Debt to GDP



## Debt Level

### Gross Government Debt to Government Revenue



# Proof that creation of the Euro was wrong?

- Widespread idea that main fault that monetary union required “political union”
- Only partially true
- Main fault: lack of Lender of Last Resort
- Plus, lack of coordination between monetary and fiscal policy

# Bail-out uncertainty

- A key element of the financial crisis (Huerta, 2010)
- Key now for Eurozone sovereign crisis
- Bouncing from “Italy cannot fail” to “Italy has to do her job, we will not help her!”
- Only solution in the short run is to have the ECB committing to buy long-term fixed rate Euro bonds at a predetermined interest rate, even in the primary market



# A return to Keynes

- Announcing commitment to purchase of long maturity fixed rates government bonds at predetermined price
- Just admit that monetary policy in times of crisis is different from that in normal times
- [Proposal by De Grauwe]

# What the ECB should do

- Follow Charles Goodhart:
  1. Maintain price stability
  2. Maintain financial stability
  3. Support the State's financing needs at times of crisis, but in normal times to constrain misuse of the State's financial powers.
- Now ECB focusing only on 1.

# No time for fundamentalism

- The ECB is already doing fiscal policy through unconventional measures
- ECB supports banks, accept debatable collateral
- Cleaner and more transparent to accept that during the crisis, monetary policy will aim at stabilizing at low levels long term interest rates on public debt

# Moral hazard: an issue for normal times

- To be tackled by credible fiscal rules for the Euro zone
- Ex ante automatic rules: insurance from ECB only if a country respects the rule, otherwise out, without exceptions

# The example of the fire brigade

- When the house is on fire one cannot ask the fire brigade to solve the “moral hazard” problem of the careless occupant smoking in the house!
- The fire has to be put off!
- When the fire has been put off, then implement rules that exclude smokers from insurance