

A feasibility check on core elements needed for "orderly" sovereign debt restructuring and/or debt mutualisation in the Euro Area

Euro Area Scrutiny

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Abstract

The purpose of this briefing note is to explore the requirements for orderly sovereign debt restructuring or the mutualisation of sovereign debt among the Euro Area Member States. The briefing has three sections. The first provides an overview of the challenges associated with restructuring sovereign debt in the euro area. The second examines the underlying need for sovereign debt restructuring and assesses how much of that need can be addressed or mitigated through the institutions for European macroeconomic governance. The third section offers policy recommendations to meet those challenges that remain.

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EXECUTIVE SUMMARY

The euro area lacks a framework for sovereign debt restructuring and it lacks a common risk free asset. Both issues are important in looking ahead to the prospect of any future crisis. Of the two, however, the creation of some kind of sovereign debt restructuring mechanism appears to attract the most political attention.

The challenge of creating an effective sovereign debt restructuring mechanism for Euro Area Member States is both generic and Europe-specific. The generic challenge is to create incentives for governments to act in a timely manner and for investors to negotiate on a cooperative basis. The Europe-specific challenge stems from the unique characteristics of the European project. European financial markets are more integrated across national boundaries than those found in other parts of the world. By implication, the interest rate risks, contagion risks, spill-over risks, and reputational risks are in many ways exaggerated both by the volume of cross-border investment and by the importance of that cross-border investment for the smooth functioning of the internal market.

The unique characteristics of the European constitutional arrangement are important as well. Euro Area Member State governments cannot be bailed out by their central banks, they should not have privileged relations with commercial financial institutions, and they cannot assume the liabilities of (or have their own liabilities assumed by) other public entities. This triple constraint places considerable political pressure both on Member State governments and on European institutions. The challenge is to ensure that all parties act within the spirit of the wider European project, including the economic and monetary union.

The distribution of sovereign debt holdings among central banks, domestic financial institutions, other domestic residents and non-residents is also important for the operation of any sovereign debt restructuring arrangement. By implication European policymakers face a complicated set of trade-offs between core European values. There is no single blueprint for a successful institutional arrangement for orderly sovereign debt restructuring. There are core areas of agreement on elements that should be included and procedures that should be followed, but there is also considerable political discretion in how they are assembled.

The question is whether sovereign debt restructuring is a priority matter for political attention either within the Euro Area or across the European Union as a whole. The answer depends upon understanding why sovereigns might need to restructure their debt and what will be the implications of sovereign debt restructuring for European integration. The causal mechanisms are both long- and short-term in development and relate to the building up of imbalances and the vulnerability of the markets – both psychological and real – to sudden shocks.

The European Union has developed strong frameworks for addressing the emergence of imbalances over the longer term. It has less robust institutions for handling short-term, exogenous shocks – particularly when those shocks fall on financial institutions. The progress made toward the completion of Europe's banking union is impressive and yet there is still more to be done. Specifically, European politicians should focus on measures that will bolster investor confidence in the robustness of integrated financial markets. The completion of Europe's banking union will provide one important area of progress. The creation of a common risk-free asset is another area that warrants attention. The use of European financial resources to bolster long-term infrastructure projects at the Member State level is important as well.

1. INTRODUCTION

The purpose of this briefing note is to explore the requirements for orderly sovereign debt restructuring or the mutualisation of sovereign debt among the Euro Area Member States. The notion of 'requirement' refers both to whether such policy instruments – sovereign debt restructuring or debt mutualisation – would be necessary in addition to how they should be designed and implemented. The conjunction 'or' is inclusive and leaves open the possibility that both policy instruments – sovereign debt restructuring and debt mutualisation – might be necessary for the stable functioning of the euro area.

1.1. The origins of the debate

This is not a new debate. The idea of developing a sovereign debt restructuring mechanism dates to before the recent crisis in the euro area and focused originally on the requirements for handling complex financial crises in emerging market economies, like Argentina or Peru (Krueger 2002). Nevertheless, the principles involved in the debate are easily transferable, even to tightly integrated financial markets like those found in the Euro Area. A sovereign debt restructuring mechanism needs to create two complementary sets of incentives, to encourage debtor states to recognize and deal with the consequences of their indebtedness in a timely manner and to encourage creditors in the private sector to negotiate collectively and constructively in reaching an agreement. During the interim, the sovereign debt restructuring mechanism needs to protect the rights of the creditors and to ensure that the state in distress has continuous access to liquidity. It is a complex and challenging task that requires the confidence of all parties to succeed.

The idea of mutualizing sovereign debt in the euro area emerged at the start of the euro area crisis from concern about the weak functioning of market mechanisms to constrain sovereign borrowers. Prior to the crisis, all sovereign debt received relatively equal treatment and so 'responsible' borrowing and 'excessive' borrowing incurred much the same pricing in the market. The original proposals for debt mutualisation argued in favour of giving privileged treatment to 'responsible' borrowing by creating a clear distinction between responsible and excessive debts (Jones 2010, Depla and von Weizsäcker 2010). Responsible borrowing would be senior in the market and would benefit from a joint-and-several guarantee; excessive borrowing would be junior in the market and would be the sole responsibility of the Euro Area Member State that issued the debt. This distinction would make it easier for market participants to differentiate between responsible and excessive borrowing and so discriminate between the two forms of indebtedness in setting prices and assessing risks. In turn, that price discrimination would create an incentive for Euro Area Member State governments to avoid excessive borrowing (European Commission 2011).

1.2. The open nature of the conversation

The two ideas have positive synergies. Sovereign debt mutualisation in the euro area would facilitate the creation of a sovereign debt restructuring mechanism by creating a strong distinction between that pool of sovereign debt that benefits from mutual support and so serves as a common risk-free asset, and that pool of sovereign debt that is the responsibility of national governments and so could be subject to restructuring in case of need. This division makes it easier for authorities to restructure sovereign debt in three ways:

- by reducing the number and type of market participants exposed to the (non-mutualised and so higher-risk) debt in need of restructuring;
- by eliminating public sector holders of that debt in need of restructuring; and

- by ensuring that a large share of Euro Area Member State liquidity requirements was covered with a joint-and-several guarantee on the mutualised stock of sovereign debt.

More important, by creating a strong price incentive for governments not to borrow excessively, the mutualisation of sovereign debt would limit the need for sovereign debt restructuring.

Neither of the two ideas found significant traction in the policy community, largely due to political opposition. The then IMF Deputy Managing Director Anne Krueger's efforts to push for a sovereign debt restructuring mechanism was vetoed by the United States in 2003. The European Commission's (2011) green paper on sovereign debt mutualisation did spark a wider conversation yet no white paper has followed that publication. Nevertheless, both ideas have nurtured useful policy innovations. The introduction of collective action clauses emerged from the debate about sovereign debt restructuring and the debate about European safe assets emerged from the discussion of debt mutualisation. By implication, these ideas still warrant close consideration even if the political climate around the more ambitious versions of the proposals is unreceptive.

The purpose of this briefing note is to continue discussion of ways to improve the functioning of European financial markets by using the proposals for a sovereign debt restructuring mechanism and the mutualisation of sovereign debt as a stimulus both to come up with fresh ideas and to reconsider older proposals. The primary focus is on how to facilitate orderly sovereign debt restructuring; the mutualisation of sovereign debt is a subsidiary and related consideration.

1.3. The structure of the note

The briefing note has three sections beyond the introduction. The first provides an overview of the challenges associated with restructuring sovereign debt in the euro area. The second examines the underlying need for sovereign debt restructuring and assesses how much of that need can be addressed or mitigated through the institutions for European macroeconomic governance. The third section offers policy recommendations to meet those challenges that remain.

2. RESTRUCTURING EURO AREA SOVEREIGN DEBT

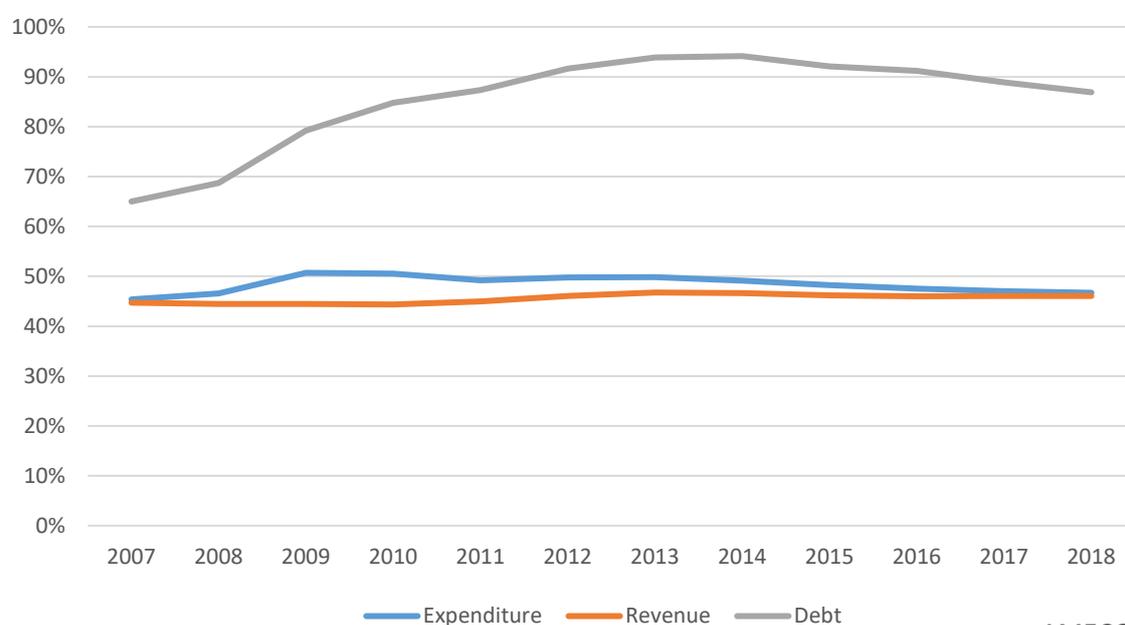
The European Union lacks a framework for restructuring the sovereign debts of Euro Area Member States. This is unsurprising from an original design perspective. Sovereign default of EU Member States was not a major consideration (and, in fairness, neither was much thought given to sovereign defaults of advanced industrial economies at the global level). There was concern about the possibility for moral hazard and monetary financing, but not sovereign debt restructuring. That situation changed with the first Greek crisis in 2010-2012 (Zettelmeyer et al. 2013). European policymakers realized both that they needed to find some solution to ensure the sustainability of Greek sovereign debt and that they needed a robust mechanism for negotiating with both the Greek government and its creditors. Belatedly, they also realized that the ad hoc arrangements created to deal with Greece were inefficient. When the Greek crisis returned in 2015, the deterioration of the economy was such that the government was tempted to 'gamble for redemption' (Bénassy-Quéré et al. 2018).

2.1. The basic problem

Both during and since the Greek crisis, European policymakers have worked hard to improve their institutions and procedures for crisis response. Nevertheless, many analysts remain concerned that a robust arrangement for sovereign debt restructuring is lacking (see, e.g., Committeri and Tommasino 2018). This is problematic for three reasons:

- First, Euro Area Member States have, on average, public sector revenue and expenditure worth approximately 45-50 percent of gross domestic product (GDP);
- Second, Euro Area Member States have, on average, general government debt worth approximately 85-90 percent of GDP (in its autumn 2018 forecasts, the European Commission estimated the value of euro area public debt outstanding at €10.8 trillion); and,
- Third, macroeconomic shocks that raise expenditures while compressing revenue growth can provoke a rapid accumulation of public debt.

Figure 1: Euro Area Public Expenditure, Revenue, and Debt to GDP



AMECO

This data can be seen in Figure 1. The term ‘approximately’ reflects the fact that these figures change over time and vary across countries. The figure reveals the pattern of accumulation over time and in relation to the gap that emerged between revenues and expenditures. It is worth noting that the total for accumulation is significantly lower than the sum of the gap. This is because nominal GDP in the euro area has grown faster than nominal government debt outstanding. Where that growth has not taken place, in countries like Italy and Greece, for example, the sum of the revenue gap more closely approximates the change in general government debt to GDP.

The basic problem is to ensure that public debt is sustainable as a function of the relative balance between revenues and expenditures and in relation to the growth of nominal GDP. Where the expectation is that public debt will be unsustainable because revenues do not match expenditures or because nominal growth is inadequate to lessen the impact of any resulting deficits, it is important for both national governments and European institutions to take remedial action. The challenge is three-fold:

- National governments need to accept that there is a problem – this is where the ‘trigger’ for any restructuring becomes important.
- Creditors need to accept to negotiate collectively to find a solution – the danger is that ‘hold-outs’ will prevent agreement in order to seek better terms for themselves.
- Some third party needs to broker the situation, protecting the rights of creditors while at the same time ensuring that the national government has access to adequate liquidity – here the danger is one of creating ‘moral hazard’ that prolongs negotiations as either side hopes for some *deus ex machina* in the form of high external growth or improved market conditions will strengthen their position, or that both borrowers and creditors will pay less attention to the prospect of sovereign debt restructuring *ex ante*.

This basic problem exists no matter what is the process used in sovereign debt restructuring. The design challenge, therefore, is to find a balance across important trade-offs in the different design features (Destais et al. 2019). Before coming to those trade-offs, however, it is worth bringing three other sets of considerations into account.

2.2. Orderliness and credibility

The first special consideration is the extraordinary nature of European financial integration. The euro area is probably the world’s most deeply integrated multi-national financial marketplace. That integration made it possible for capital to flow freely from countries that had surplus savings to countries that offered attractive opportunities for investment. Moreover, the political commitment to integration – including monetary integration – made such capital flows more likely than has been seen in other parts of the world that have liberalized capital flows across national boundaries (Blanchard and Giavazzi 2002).

Much of the cross-border investment took place in sovereign debt instruments, as investors – usually banks – with access to savings in the wealthier parts of the euro area used those funds to purchase government bonds in countries that offered higher rates of return. The evidence for these cross-border investments can be found in the Bruegel database of sovereign bond holdings developed in Merler and Pisani Ferry (2012) and that is still being updated. This cross-border movement was ‘investment’ more than it was ‘borrowing’ insofar as the price of government bonds increased alongside increases in foreign holdings of sovereign debt instruments. The result was a rapid convergence of long-term nominal yields on government debt across the euro area (Codogno, Favero, and Missale 2003).

Over time, this convergence in nominal yields allowed governments in those countries that received the investment to adapt their fiscal accounts in line with the lower burden of debt servicing requirements. Convergence in nominal sovereign debt yields across countries also allowed those governments that received foreign investment the opportunity to roll off high coupon sovereign debt instruments with relatively short maturities and to replace them with lower coupon instruments with relatively longer maturities. According to the Italian Treasury, for example, the (weighted) average residual maturity of outstanding public debt was 5 years and 8 months in January 2000 and it was just under 6 years and 6 months by December 2005; meanwhile, the yield at issuance fell from just under 4.8 percent to just under 2.5 percent.

The depth of euro area financial integration in sovereign debt markets enhances four forms of risk associated with any process of sovereign debt restructuring, and related to interest rates, contagion, spill-over, and reputation (Jones 2015a). Specifically, the very high degree of pre-crisis financial integration raises the prospect that a more traditional form of home bias will reassert itself and that capital will not only return home from where it has been invested abroad but also prove more reluctant to come back once the crisis has passed.

- The interest rate risk is that investors will sell sovereign debt instruments for any government they know to be approaching the limit at which some sovereign debt restructuring could be triggered or that might get caught up in some more discretionary sovereign debt restructuring procedure. This is what happened to Greece after the March European Council summit in 2010.
- The contagion risk is that the initiation of a sovereign risk procedure for one country will change the attitudes of foreign investors towards other countries and so trigger sales of sovereign debt instruments in those third markets. This is what happened in Ireland in 2010, and Portugal and Italy in 2011.
- The spill-over risk is that any sudden decline in sovereign debt prices due to sales made by foreign investors will have an adverse impact on the asset portfolios of domestic holders of home country sovereign debt. Here too, the concern is mostly for domestic banks which hold, on average across the euro area, between 15 and 18 percent of their home country's sovereign debt on their balance sheets both as investments and for use as collateral in routine treasury operations (Manna and Nobili 2018: 8). Where the losses for domestic banks are large, they may create a doom-loop with sovereign finances as governments are forced to borrow in order to shore up the banks. This is what happened in Spain in 2012.
- The reputational risk is that foreign investors will change their attitudes in a way that reinforces home bias and so reduces their willingness to engage in cross-border investment. This change in attitudes manifests as a form of financial market 'disintegration' that results in a permanent wedge in the cost of capital between those countries where savings are relatively abundant and those countries where savings are needed to finance investment. Such financial disintegration has been a concern of the European Central Bank since 2012.

No sovereign debt restructuring procedure can eliminate these risks entirely. Such risks stem from the need for sovereign debt restructuring and not from the procedure, *per se*. Nevertheless, a robust, transparent, and predictable procedure should limit the incentives for investors to 'cut and run', it should reassure them about which countries or governments are likely to be affected and which are not, it should insulate all creditors from unnecessary losses, and it should limit reputational damage by improving information flow about credit risks long before any sovereign debt restructuring has to take place (Committeri and Tommasino 2018). The point to underscore in this context is that the depth and promise of European financial market integration makes managing these risks even more imperative than it would be in a more fragmented marketplace or a closed national economy.

2.3. The 'no-bailout' clause

A second special consideration is the European treaty requirement to avoid bailing out national governments that get excessively into debt. This treaty requirement is based on the principle of national responsibility and the goal is to avoid a specific type of moral hazard through which national governments not only borrow excessively but also undermine the efforts of the European Central Bank to promote price stability across the euro area. The need for this clause is practical as well as ideological or ethical. The architects of Europe's monetary union were well-aware of the fact that the irrevocable fixing of exchange rates across national currencies would release national governments from the balance of payments constraint. The result is not just a common currency but also a common pool of liquidity that can be used to support cross-border investment and borrowing (Schelkle 2017). This is a big part of the reason why European financial markets are so deeply integrated. Hence it is important to place some constraint on how national governments make use of their enhanced access to credit (Jones 2003).

The conventional reference to these constraints focuses on the so-called 'no bail-out' clause. In fact, however, the Treaty on the Functioning of the European Union includes three articles that are relevant to the principle of national responsibility and to the effort to avoid creating moral hazard through monetary integration (Baglioni and Bordignon 2018):

- Article 123 prevents the European System of Central Banks from providing public entities – meaning the European institutions as well as national and subnational governments – with overdraft facilities. The same article prevents central banks from purchasing of sovereign debt instruments directly from national treasuries.
- Article 124 prevents public entities from establishing any privileged access to financial institutions 'not based on prudential considerations.'
- Article 125 prevents any one group of public entities from being 'liable for or assume the commitments of' any other entity or group of entities.

This series of injunctions puts national governments in a triple bind. To begin with, it prevents national governments from relying on their central banks to act as lender of last resort for their sovereign debt instruments. Many analysts refer to this situation as being analogous to forcing governments to borrow in a foreign currency – with the implication being that sovereign borrowing is inherently riskier in this respect inside the euro area than it would be outside a monetary union as a consequence (De Grauwe and Ji 2018).

National governments should also be constrained from relying on domestic banks to fulfil the lender-of-last-resort function that central banks are prevented from assuming. Although this point is not often raised in the debate about the exposure of national banking systems to their home country sovereign debt, the intent of Article 124 appears to be to prevent special treatment. The point here is not that a tendency for banks to expose themselves to home country sovereign debt – like that revealed by Manna and Nobili (2018) – is *a priori* evidence of action against the spirit of the treaty. Rather it is to question whether systematic reliance on home country banks to prop up national sovereign debt markets would be consistent with the intent of the treaty.

Neither national governments nor European institutions – including the European Stability Mechanism (ESM) – can bailout Member States either. They can provide financial assistance, but only under conditions of strict conditionality and without absolving national governments in distress of their debts. On the contrary, national governments remain responsible for the fulfilment of their obligations in addition to meeting the requirements for receiving assistance including the repayment of any aid once the program is completed (Grund and Stenström 2019: 809-810).

Within this context of constraints on other potential lenders of last resort, the no bailout clause makes the prospect of some form of sovereign debt restructuring more likely. This reliance on sovereign debt restructuring creates a moral hazard of a different kind because the heads of state or government meeting in the European Council have the greatest scope for political discretion. If central banks are tightly constrained in their lender of last resort function, domestic banks are prevented by regulators from giving priority to stabilizing domestic sovereign debt markets (for possible regulatory instruments and their effectiveness, see, Lanotte et al. 2016), and no public entity can assume the debts of another, then the heads of state or government will face considerable pressure to find a way to relax one or more of these constraints when responding to an impending crisis. Even though the facility was never used, the June 2012 decision to permit ESM resources to recapitalise distressed banks directly might be interpreted as one such form of relaxation (Dijsselbloem 2018: 138-142).

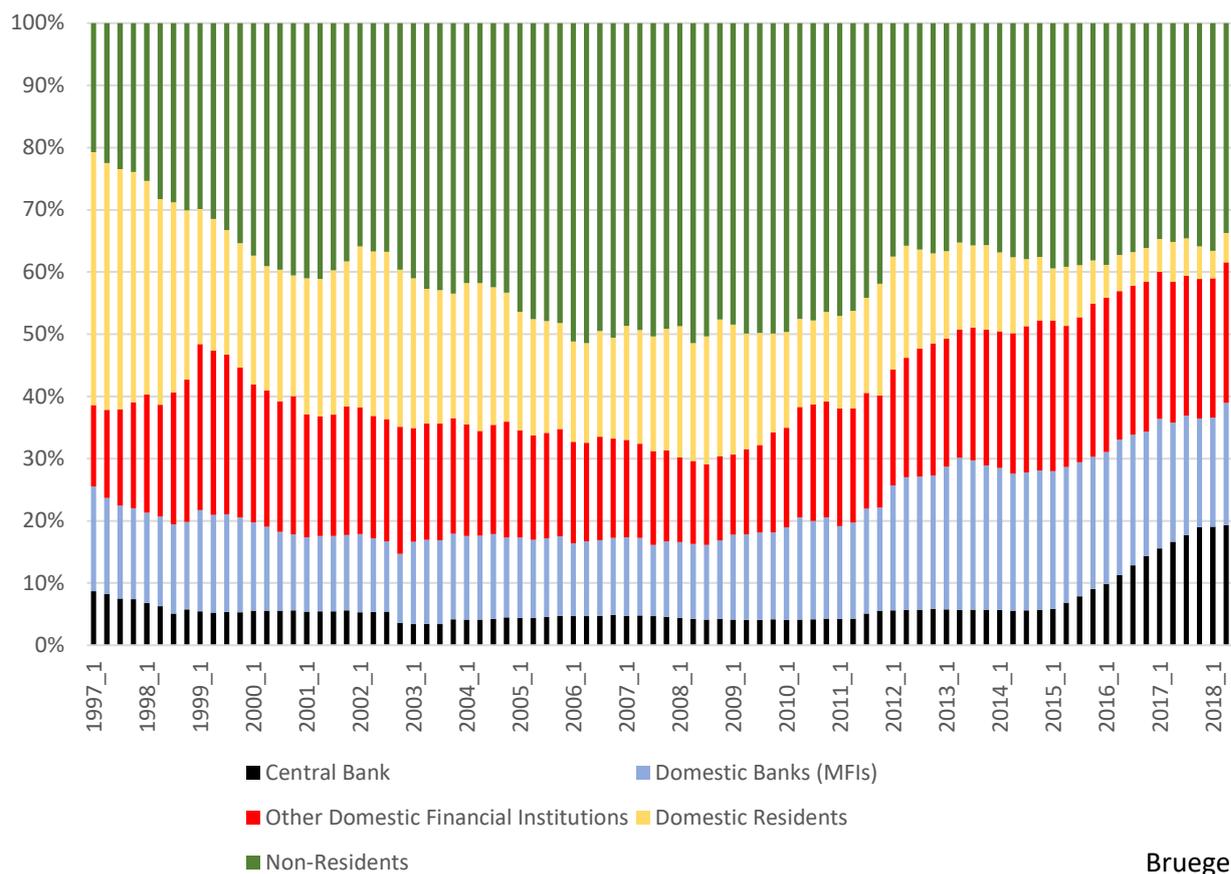
2.4. The distribution of debt holdings

A third special consideration arises from the distribution of sovereign debt holdings. This distribution matters because of what it implies both for the pattern of any restructuring and for the consequences in terms of potential spill-overs. In an ideal world, all creditors would be equal in terms of both their willingness to participate in any restructuring and in their ability to absorb losses. In reality, both characteristics vary significantly depending upon who holds the debt. To illustrate why, it is useful to focus on the Italian case. The Italian case is interesting not because there is any reason to believe that Italy will require sovereign debt restructuring but because it has a large stock of debt outstanding and the data on holdings is readily available. Figure 2 provides the share of Italian debt held by each of five categories of investors:

- Central banks, which hold sovereign debt both as collateral and through the European Central Bank's large-scale asset purchasing program;
- Domestic banks, which use sovereign debt for treasury operations and also as an investment or asset;
- Other domestic financial institutions, like insurance companies, which also use sovereign debt instruments as collateral or as assets;
- Domestic residents, which could be firms but in the Italian case is also likely to be households; and,
- Non-domestic resident, which includes the bulk of foreign investors (meaning except those foreign entities which operate a domestic subsidiaries of foreign banks).

The central bank holdings are important insofar as they are unlikely to be involved in any sovereign debt restructuring. Like official creditors, the central banks are effectively senior in the market. This principle was clearly established in the case of Greece and applies to the roughly €2.17 trillion in sovereign debt holdings that the European System of Central Banks had accumulated by the time it stopped net purchases of public sector securities in December 2018. Central banks hold approximately 20 percent of Italian sovereign debt instruments (mostly at the Banca d'Italia), which means that – at most – only the remaining 80 percent is available for restructuring, as governments face strong pressure to shield at least some domestic residents.

Figure 2: Italian Sovereign Debt Holdings by Sector (quarterly, percent)



The domestic banks hold another 20 percent of Italy’s sovereign debt. This is up considerably from the approximately 12 percent that they held in 2007, prior to the crisis. Much of the increase took place between 2011 and 2013, when the banks absorbed roughly 10 percent of the Italian sovereign debt stock that was shed by non-residents. Domestic bank holdings peaked in 2013 at around 24 percent of the total debt stock. As mentioned, the concern is that any restructuring of this volume would have an impact on bank solvency that could set off a doom loop like the one seen in Spain in 2011 (Zettelmeyer 2018). A related concern is how much any restructuring or adverse movement in sovereign debt prices would impact on bank profitability and therefore credit conditions in Italy (Pagano 2016). Such concerns are a subject of considerable debate (Lanotte et al. 2016).

The impact of any restructuring on non-bank financial institutions and other domestic residents attracts less attention in the literature. Instead, the focus tends to fall on the actions of distressed sovereign debt investors who presumably fall in the non-resident category and who are most likely to behave strategically in any restructuring negotiations. This is true particularly given the dual-limb aggregation system used in European collective action clauses which give investors disproportionate leverage if they can capture a large share of a specific bond issue. Hence the concern is that this group will find privilege in any restructuring process over those other groups, like domestic residents, that are less well represented. Moreover, the larger the presence of central bank holdings, the greater will be the incentives for strategic investors to seek to escape the burdens of any restructuring. A single-limb aggregation like that discussed at the December 2018 Euro Area Summit would make it harder – but still not impossible – for strategic investors to exert leverage by closing off the opportunity to build up a large presence in a single debt issue.

2.5. Trade-offs in designing a sovereign debt restructuring mechanism

The combination of general and specific considerations makes it difficult to identify a sole template for designing an effective sovereign debt restructuring mechanism in the euro area. Instead, policymakers face a series of complex trade-offs, many of which are interconnected. This focus on policymakers is important because they are the ones who must make the design decisions; market participants react to those choices and so are considered below.

Christophe Destais and his colleagues (2019) organise the trade-offs faced by policymakers into five sets of issues. This analysis borrows much of their analytical structure, with only slight modification to fit the wider scope of the analysis in this briefing note. Those clusters are:

- Independence versus politics
- Discretion versus automaticity
- Quantity versus quality
- Ease of transition versus strength of the steady state
- Stability versus transparency

The point about independence versus politics can be read in two ways. On one level, this is a question about whether more power over any restructuring process should be given to a 'political' European Commission or whether it should be given to a more 'independent' European Stability Mechanism. The concern is that the European Commission would either bow to pressure from the debtor country or be seen to bow to such pressure. Either way, the assignment of responsibility to the Commission creates incentives for either debtors or creditors to delay any move toward restructuring. This is not an argument for eliminating the European Commission from any restructuring process altogether. Rather it is an argument for applying the same pattern of operations that is written into the ESM Treaty which grants the European Commission responsibility for assessing strategic implications, debt sustainability, and financing needs (Article 13, 1) and yet reserves the right of decision on whether to grant outright or precautionary assistance to the Governing Board of the ESM (Article 13, 2; Article 14, 1). This is the pattern that the Eurogroup suggested in the term sheet for ESM reform proposed in December 2018.

Another way to read this trade-off, however, is by examining the decision-making procedures of the ESM and comparing those to the European Commission. In doing so, it is useful to distinguish between technical independence and political independence. The ESM and the Commission are both technically independent. Nevertheless, it is possible to argue that the ESM is the more 'political' of the two bodies because of the way its decisions can be influenced by the Member State governments, which must agree unanimously to any positive action (Baglioni and Bordignon 2018). The Commission is still 'political' and yet the exercise of political influence through the College of Commissioners is more subtle. Specifically, the ESM is more likely to bend to the influence of creditor countries than to countries in need of assistance, whose assent is required for unanimity. This design feature is not inevitable. The ESM could be given more insulation from political influence by changing its voting rules or allowing it more freedom of manoeuvre in times of duress. The fact that key creditor countries do not want the ESM to move in that direction is indicative of their political incentives to keep the ESM decision-making structures as they are. Hence, what looks like a choice between independence and politics may in fact be a choice between one kind of politics and another.

If that political trade-off is the case, a workaround would be to ensure that any trigger for sovereign debt restructuring is automatic rather than discretionary. For example, any country that applies for ESM support should experience an extension of its debt maturities and any country that receives a negative debt sustainability analysis from the European Commission should have to enter into some kind of restructuring negotiations – perhaps with different patterns of negotiation being triggered by different

levels of debt outstanding or different financing requirements. This is much like the two-stage procedure recommended by Jochen Andritzky and his colleagues (2018). As they explain: ‘using simple and hard-to-manipulate criteria prevents judgements from being distorted too heavily by political considerations’ (p. 7).

On the surface, this approach sounds more automatic than discretionary. Nevertheless, Andritzky et al. (2018) concede that automaticity has disadvantages because it creates incentives for early capital flight or adverse speculation (see also, Pavlidis 2018: 5). Hence, they build in elements of discretion around a preliminary debt sustainability analysis to trigger the maturity extensions followed by a more profound debt sustainability analysis leading to a decision on whether to proceed with restructuring. The point to note, moreover, is that such debt sustainability analysis rests on judgment – which could result in denying support to governments that could return to solvency with sufficient liquidity assistance. The political question is whether such an error is preferable to the prospect of funding governments that are insolvent (Destais et al. 2018: 4; Zettelmeyer 2018: 73). Even the workaround for choosing between politics and independence requires a political trade off.

The structure of the response implies trade-offs as well. Destais et al. (2018) focus both on the size of the restructuring effort and the choice between maturity extensions and principal reductions. Here the issue is whether to make a meaningful reduction up front at the risk of imposing too great a loss on creditors or making a more gradual reduction at the risk of leaving the debtor country with a still-unresolved debt burden that will only have to be corrected later. The experience of Greece looms large over this consideration. So do some of the innovations that came to prominence during the different Greek bailouts. The introduction of ‘state-contingent’ bonds – or bonds that cost less to service or go into moratorium when GDP growth decelerates – is one way to split the difference. The problem is that such bonds might show many of the same problems with investors that a rigid restructuring rule displays, leading to investor flight from the bonds as growth performance falls toward the trigger to a lower payout or standstill (Demertzis and Zenios 2018).

Another problem with state-contingent debt is how to bring it onto a market that is dominated by more conventional bonds. This is a problem that also applies to new contract forms like a collective action clause with a single limb aggregation. It applies to more exotic instruments used to lower the risk of a bank-sovereign doom loop as well (De Grauwe and Ji 2018). Such instruments may work once they are dominant in the market; what is less clear is how to convince investors to purchase those instruments during the transition period. It is also unclear how well the instruments will work in a mixed market. The experience with those collective action clauses that have been introduced since 2013 is unimpressive (Zettelmeyer 2018). That does not mean such clauses will not be useful once they are dominant in the marketplace; it just means that their effectiveness is reduced during the period in which they are effectively junior to the bonds that already circulate. This transition problem can be mitigated by weakening those characteristics that help to balance between risk reduction and risk sharing, and yet such adjustments make the instruments less useful as well (Destais et al. 2018: 10).

A final trade-off focuses on the implications of bringing in transparent rules to bear on the risks that arise from the interdependence between banks and sovereigns. There is clear concern that bank exposure to sovereign risk creates a danger of contagion. As a result, there are many proposals to limit bank exposure to sovereign risk either through regulatory caps or through progressive charges (Véron 2017). The concern is that domestic banks are the most effective source of liquidity for governments whose sovereign debt markets come under pressure. This privilege may run against the spirit of the European treaties, but it is nonetheless effective. By constraining bank holdings of domestic sovereign debt, European regulators may inadvertently put government finances at risk (Lanotte et al. 2016). That risk can be managed – most obviously through an effective sovereign debt restructuring mechanism –

but only if the various trade-offs are calibrated in a way that works effectively (Destais et al. 2018: 12-13).

3. WHY WE WOULD NEED TO RESTRUCTURE EURO AREA SOVEREIGN DEBT

The conclusion to the previous section is that it is possible to imagine a European sovereign debt restructuring mechanism and yet there is no clear blueprint for building one and there are many areas for exercising discretion about how, and how quickly, a sovereign debt restructuring mechanism can be created and supported. The assumption throughout the discussion is that such a mechanism is both absent and necessary. The evidence underpinning that assumption is the recent experience in Greece – together with the programs that were required for Portugal, Ireland, and Cyprus. Given that the governments of these countries got into trouble, it is necessary to consider how European policymakers can prepare for the fallout from the next crisis (see, e.g., Grund and Sendström 2019: 797-798).

The logic behind this setup is compelling and yet it takes the need for some framework for orderly sovereign debt restructuring as given. In doing so, the analysis skips over the reasons why national governments require sovereign debt restructuring in the first place. Those causal mechanisms are important to understand because policymakers may be able to shut them down directly. The creation of a sovereign debt restructuring mechanism can help in this regard by strengthening the incentives for national fiscal policymakers to act more responsibly, particularly if market participants believe restructuring to be a credible possibility and so bring greater discipline to bear through their pricing decisions. Nevertheless, that is only one of many possible instruments that can be brought into play. Of course, there may always be some need to restructure sovereign debt in a future crisis. The question is how much effort (or political capital) should go into the institutionalization of a formal mechanism that could be invested in other directions.

3.1. When does sovereign debt need to be restructured?

The realization that sovereign debt requires restructuring often takes place suddenly, but the build-up to the problem is a slow process. It is useful, therefore, to distinguish between longer-term and short-term causal mechanisms.

The longer-term causal mechanisms derive from sustained imbalances. These imbalances can be on government accounts, as in Figure 1, but they can also emerge through the accumulation of private sector debt or asset prices. In other words, either the public sector creates the debt on its own – as Greece did – or it absorbs that debt from the private sector – as happened in the case of Ireland. If we are going to talk about the need for sovereign debt restructuring, the debt has to come from somewhere.

Imbalances can be sustained for a long time (Reinhart, Reinhart, and Rogoff 2012 :83-84). A crisis typically requires some sort of trigger. That trigger can be a sudden slow down in economic activity that changes the balance between fiscal revenues and expenditures (again, think about Greece); it can be a sudden rise in private sector defaults or a decline in asset prices that pushes private debt onto the public sector (like subprime mortgages in the United States); or it can be a sharp movement in relative currency values that creates a mismatch between domestic income and foreign borrowing (like the Swiss franc mortgages in Hungary).

Not every combination of longer-term imbalance and short-term trigger, however, results in a sovereign debt restructuring. An essential third component is the loss of confidence among market

participants that (a) the sovereign will not be able to meet its obligations or (b) that no-one else will be willing to purchase sovereign debt instruments without offering only a deeply discounted price. These notions of 'market confidence' point in different directions, often referred to in terms of 'solvency' and 'liquidity'; in practice, however, they are closely connected. So long as market participants are willing to roll over sovereign debt at sustainable yields, a government can afford to keep servicing its debt and so avoid restructuring. Japan is the most famous case of this phenomenon. But it is also worth considering the case of Belgium. Belgium had relatively high levels of public debt prior to the crisis (despite many years of consolidation efforts); Belgium also had relatively large banking conglomerates with exposure to foreign assets (Chang and Jones 2013). When the economic and financial crisis struck in 2008, the Belgian government faced not only a rise in fiscal expenditures over revenues but also the necessity of absorbing large bank bailouts. This combination of adverse factors coincided with a prolonged political crisis after the June 2010 parliamentary elections as Belgian political parties struggled to form a government. That political stalemate came to an end in late 2011 with a sudden spike in the spread between Belgian and German long-term sovereign debt. Belgian politicians recognised that they needed to act to restore credibility in the market and so they at last agreed to form a government. Market pressure on Belgian government securities subsided almost immediately and the country avoided a larger crisis.

3.2. Greece as a case study of the need for sovereign debt restructuring

The Greek case is different from the Belgian case in important respects. Greek public debt levels were higher at the start of the crisis in 2007, standing at 103 percent of GDP versus 87 percent, and Greece did not have the same history of fiscal consolidation that Belgium had, for example. At the same time, however, Greece experienced nothing like the banking crisis that Belgium had to navigate with Dexia and Fortis. Clearly, the governments of the two countries faced different challenges both in terms of longer-term imbalances and short-term shocks.

The two governments also started at very different levels of credibility in the markets. Here it is useful to look away from the political turmoil that both countries experienced. The important point is that where Belgium made obvious efforts to consolidate its fiscal accounts prior to the crisis and to manage the fiscal consequences that the crisis left behind, Greece struggled to manage its fiscal position both before and during the crisis (Papaconstantinou 2016).

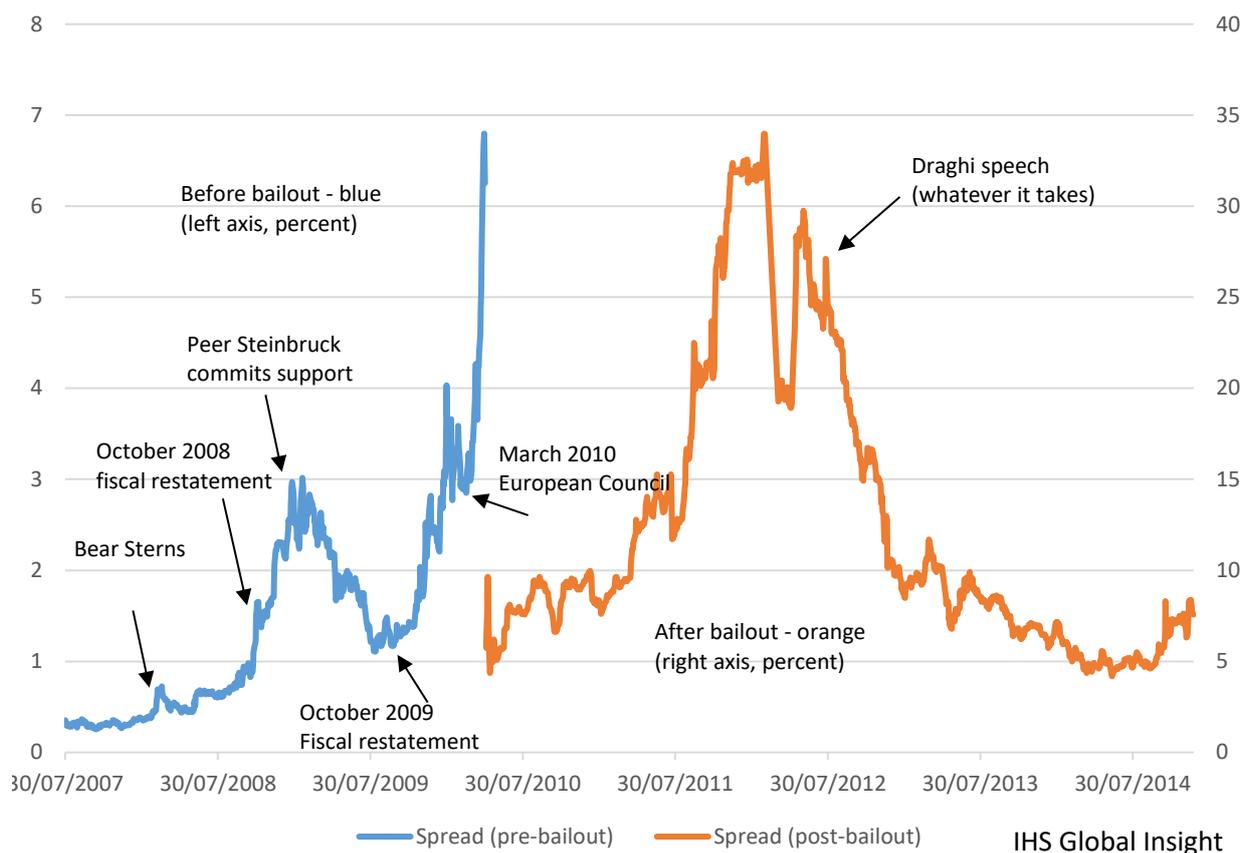
The question is whether there is anything Greece or anyone else could have done provide market participants with the confidence that the Greek government would be able to meet its obligations or that someone else would step in to purchase those debt instruments without demanding a deeply discounted price. Clearly that was the goal of Greek Prime Minister George Papandreou. Given how events unfolded it is impossible to answer the question definitively. The point to note, however, is that the ambiguities go both ways and there is substantial evidence that it was possible to strengthen Greece's market credibility in ways that would lower the government's cost of borrowing.

This evidence runs against the conventional narrative which dates from the start of Greece's credibility crisis to the October 2009 elections (see, e.g., Zettelmeyer et al. 2013: 518). An alternative narrative would start more than a year earlier in March 2008, when the European Commission raised concerns about Greek fiscal accounting. That warning came in the shadow of the Bear Sterns crisis and triggered

a doubling of the spread between Greek and German sovereign debt. The European Commission sent a team to Greece over the summer of 2008 to help improve the government's financial statistics. The result was a modest restatement of Greek fiscal accounts in October 2008 that caused the spread

between Greece and Germany to double again. Subsequently, the markets turned against Greek sovereign debt and the pressure increased through January 2009, when Standard & Poor's downgraded the country's creditworthiness citing concerns about the Greek government's fiscal accounting. By February 2009, the spread between Greek and German bonds was already at 300 basis points (or three percentage points) – which is close to where the spread between Belgian and German bonds was at the height of the Belgian crisis (Jones 2015b: 826).

Greece managed to avoid a crisis in 2009 because of an intervention by German Finance Minister, Peer Steinbrück, that restored market confidence both in the ability of the Greek government to meet its obligations and in the willingness of the German government to ensure that there would be a buyer for Greek sovereign debt (Benoit and Barber 2009). Moreover, that confidence lasted through the fiscal revisions the Greek government announced both before and after the October 2009 elections. Market confidence in Greece declined rapidly only once it became clear that the government would not receive support until it lost access to the markets. That confidence only returned when ECB President Mario Draghi announced his commitment to do whatever it takes to stabilise sovereign debt prices for governments that accept conditionality and retain market access. Figure 3 provides the record of the spread between Greek and German government bonds both before and after the Greek bailout in 2010. Again, the goal is to demonstrate that market confidence in Greek sovereign debt can be influenced by policy actions taken in other member states or European institutions. The open question is whether such confidence would have been enough to avoid restructuring Greek debt altogether.

Figure 3: Greek-German 10-year Spread (before and after bailout)

3.3. What are the alternatives to sovereign debt restructuring?

Sovereign debt restructuring would take place when longer-term imbalances collide with short-term shocks and a loss of market confidence. Therefore, the alternatives to sovereign debt restructuring are to avoid longer-term imbalances, to dampen short-term shocks, and to bolster market confidence. European institutional responses to the crises have focused primarily on avoiding longer-term imbalances. They have made some progress in dampening short-term shocks. They have made less progress in bolstering market confidence.

The EU procedures to prevent longer-term imbalances centre on the European Semester – including the whole array of fiscal coordination requirements – and the macroeconomic imbalances procedure. They are complemented by the single supervisory mechanism (SSM) for euro area banks, the single rulebook of banking regulations, and the single resolution mechanism (SRM) also for euro area banks. These procedures and institutions are not perfect. Critics like Waltraud Schelkle (2017) claim that fiscal coordination places too much emphasis on consolidation and austerity measures during economic downturns; the macroeconomic imbalances procedure places too little emphasis on correcting current account surpluses; and the single supervisory mechanism allows too many loopholes for smaller banks to avoid scrutiny and national governments to evade strict banking recovery and resolution requirements. Clearly there is scope for the trade-offs implicit in the design of these institutions and instruments to be recalibrated if necessary. The point to underscore is simply that this is an area where the European Union has made considerable progress both during and since the economic and financial crisis, particularly with respect to the Banking Union but also including the ESM (Epstein 2017: chapter 5). By contrast, the European Semester has proven less effective than originally

anticipated (see, e.g. Darvas and Leandro 2015, Gross and Alcidi 2015). This may imply limits on how far recommendation based on supranational rules may be imposed on national governments.

The institutions to soften the impact of sudden shocks or to redistribute the burdens of adjustment away from public finances are less comprehensive. Here the ESM has a particularly important role to play. Nevertheless, most of the burden sharing takes place within countries, either through creditor involvement in banking resolution and recovery or through strengthened insolvency frameworks for non-financial corporations. There is some possibility for burden sharing through shared resolution financing and some talk of burden sharing through the reinsurance of national unemployment systems or national deposit insurance arrangements. It is instructive to note, however, that the June 2012 proposal to allow direct banking recapitalisation from the ESM has been effectively dismantled.

The debate about developing some mechanism for sharing adjustment costs remains an active one – particularly with respect to the possibility of providing reinsurance for national unemployment benefits (see, e.g., Bénassy-Quéré et al. 2018: 14-16). Much of that debate draws lessons from the experience of the United States. Proponents of cross-border burden-sharing point to the functioning of the U.S. tax and transfer system. Opponents point to the refusal of the federal government to bail out state and local governments. Both sides of the argument show areas of confusion about how U.S. public finances work.

To begin with, the U.S. tax and transfer system is inequitable across states in terms of its stabilisation effects. For example, the U.S. federal income tax system is progressive, which means that only the top half of tax payers pay any federal income tax and the top 20 percent pay the bulk of the taxes. Moreover, the distribution of wealthy citizens is highly concentrated in coastal urban areas. By implication, the wealthy coastal urban areas pay the bulk of the taxes, but they also benefit from the bulk of the stabilisation that takes place when income levels change. At the same time, many of the federal transfer benefits U.S. citizens receive depend upon matching resources from state and local governments. Wealthier states have more resources to offer in matching and so receive higher per capita federal benefits. The implicit redistribution from poorer states to wealthier states is counterintuitive (Jones 2016).

Another source of confusion concerns the no bailout rule. It is true that the U.S. federal government does not bailout state and local governments directly. Nevertheless, the federal government does deploy considerable financial resources to help out state and local governments when they face some kind of disaster. The resources provided in the face of natural disasters are the most obvious source of assistance, even if they tend to get politicised depending upon which state is the recipient. The resources provided in the event of financial disaster are less well understood. For example, the federal government will push state-chartered banks into mergers with federally chartered institutions – or push them to accept federal charters – if that is necessary to prevent the banks from undermining state deposit insurance programs. During the Savings and Loans crisis in the 1980s, for example, the federal government staged a wholesale intervention in a nominally 'state-run' sector in order to prevent state public finances from collapsing (Day 1993, Mason 2004). Translated into European institutional terms, the U.S. federal government adheres to the no bailout clause, but it also engages actively in direct recapitalisation.

The kind of fiscal burden sharing that takes place in response to economic shocks, as opposed to bank failures, may prove unnecessary. As Jakob De Haan and Patrick Kosterink (2018) point out, business cycles across Euro Area Member States are increasingly correlated and the kind of asymmetrical shock that is assumed in most fiscal stabilisation models can be handled with national fiscal resources. Following this argument, so long as European efforts to avoid excessive imbalances in one or more Member State of the Euro Area succeed, national governments should not require further European

assistance. The challenge is whether national governments can do enough to respond to country-specific or even more general economic downturns while maintaining the confidence of market participants.

3.4. Confidence and Credibility

Although this note previously described the confidence of market participants as a function of their belief that a government will be able to meet its obligations or that those market participants will find a buyer for their assets who does not demand a deep discount in prices, it may be easier to break these concerns up into four more general characteristics: liquidity, safety, convertibility, and continuity. Financial market participants want to know that they will be able to exchange the securities that they hold freely, that they will be able to preserve as much of the value of the principal as possible, that they will be able to match their assets to their liabilities, and that their assets will benefit from a continuous stream of income over time. The purpose of financial market institutions – meaning both regulators and market infrastructures, like clearing houses, payment systems, or communications channels – is, insofar as possible, to ensure that market participants have access to liquidity, safety, convertibility, and continuity. Individual assets should carry specific risks; the goal is simply to ensure that all assets do not fall in attractiveness because the structures of the financial system have broken down.

The role of policymakers is to design and maintain effective institutions. This role requires effective decision making and often involves significant trade-offs. That is why Section 2.5 above focused on the policymaking perspective in sketching the complicated calculus involved in building a framework for the orderly restructuring of sovereign debt. Once the institutions are in place, however, the question shifts to focus on whether they provide the characteristics that market participants require and whether they succeed in inspiring market confidence. Hence this section shifts from the trade-offs confronting policymakers to the implications for market participants. Some of these implications are mechanical; others are psychological. Depending upon how market participants perceive what is happening around them, the mechanical and psychological implications are not always connected.

The Euro Area ensures liquidity through the smooth functioning of the real time gross payment system (TARGET2) that connects the corresponding central banks of the euro area. This is a mechanical feature of the infrastructure underpinning Euro Area financial markets. As Waltraud Schelkle (2017) explains, this system proved to be remarkably effective during the crisis insofar as it succeeded in connecting those parts of the euro area with surplus liquidity to those parts of the euro area that were experiencing a flight of capital. Observers may have grown alarmed at the sudden widening of net positions on national TARGET2 accounts and yet, Schelkle argues, that was only proof that the euro was functioning as a common currency. Without those liquidity transfers, countries experiencing capital outflows would have inevitably faced a balance of payments crisis.

Even if the circulation of liquidity worked, however, the ability of investors to preserve capital did not. This is where the complaint about the absence of a common European safe asset is important. Here the focus is on market participants and not governments. Financial market participants looking to preserve the principal of their investments inevitably sold riskier assets to move to assets of higher quality. Within national economies, the highest quality assets were sovereign debt instruments. Across national economies, however, some sovereign debt instruments were higher quality than others. At different stages of the crisis, therefore, investors sold the bonds of countries they believed to be riskier in order to buy the bonds of countries they believed to be more secure. Such transactions fuelled the outflow of capital from distressed countries, lowering the value of sovereign debt instruments, raising the yields on government bonds, and imposing losses on the domestic banks that were exposed to those bonds. The early proposals to create mutualized sovereign debt instruments sought to create a new safe asset that would make it possible for financial market participants to preserve the principal of their investments without having to move capital across national borders. When those proposals failed to

gain traction, the discussion moved to synthetic 'safe bonds' that could play the same role without the joint-and-several commitment that debt mutualisation would entail (Brunnermeier et al. 2016).

The proposal to create a synthetic risk-free asset has captured significant attention within the community of central bankers. It is not without its critics, however. As Paul De Grauwe and Yuemei Ji (2018) note, such synthetic instruments would nevertheless co-exist with sovereign debt instruments as well as consisting of them. As investors shifted away from sovereign debt they believed to be most at risk, they would necessarily lower the value of the synthetic assets as well. In this way, the synthetic bond is not as risk free as the strongest sovereign debt used in its own securitisation structure and hence not a clear substitute for debt mutualisation.

Another criticism came from the opposite direction. Daniel Gros (2018) noted that the main difference between a financial instrument created to serve as a risk-free asset and a fund with an equally diversified investment portfolio is primarily regulatory. Hence it would be easier to create a standard for diversification in private sector portfolio management than to create an entirely new asset class. This criticism does not avoid the problems raised by De Grauwe and Ji (2018), but it does offer a simpler solution to protect the value of capital invested without forcing financial market participants to move that capital across national boundaries.

The debate about risk free assets remains incomplete. There are significant advantages to any formula that helps to prevent the unnecessary cross-border movement of capital. First and foremost among these is the possibility of fending off speculation that one or more governments will be forced to close its capital markets or, in extremis, leave the euro area. This is where the point about convertibility becomes important. Although it is common to argue that governments in the euro area necessarily borrow in a foreign currency because their central banks cannot print euro to validate sovereign debt, such claims represent only part of the problem associated with foreign borrowing. The larger part of the problem stems from convertibility risk. This is the risk that investors will find their assets tied up in a currency that is rapidly losing value, as happened to those who invested in Iceland prior to the crisis, or that borrowers will see their debts rise suddenly relative to their sources of income, which is what happened to many households that took out Swiss Franc mortgages in countries like Hungary.

Euro Area Member State governments may not be able to instruct their central banks to print money, but they should be confident that their assets and liabilities will continue to be denominated in the same currency. This is the point that Mario Draghi made in his famous 'whatever it takes' speech in London in July 2012. It is also the reason that the ECB announced its intention to engage in outright monetary transactions to support the sovereign debt markets of those governments that requested assistance, accepted to participate in a reform program, and retained access to financial markets. These efforts to address convertibility risk played a huge role in restoring market confidence despite the absence of a risk-free asset. Indeed, the success of the ECB's intervention may have pulled away some of the sense of urgency among European politicians who perceived an opportunity to slow down or even reconsider some aspects of the Banking Union. Hence, while the European Central Bank has remained insistent on the need for some kind of common funding for banking resolution and for the creation of a common European Deposit Insurance Scheme (EDIS), a number of Member State governments have suggested that these institutions are unnecessary.

As argued in the previous section, pooled financing for banking resolution and deposit insurance is one area where the U.S. government provides continuity – even when state insurance schemes are ostensibly responsible and despite federal reluctance to bailout state and local finances. The European debate over resolution financing and deposit insurance is still under way. It is too early to prejudge how that debate will end. Instead it makes more sense to underscore another area where federal funds in the United States provide continuity. That is in the area of large infrastructural investment. If there is a clear argument for the European Union to play a similar role, this is one area where centralised European resources could make a difference – which is a point that the Juncker Commission recognised implicitly in its efforts to promote large-scale European infrastructural investments. The problem with sustaining large infrastructure projects is not a matter of asymmetric shocks, it is a matter of

prioritisation. Even faced with a symmetrical shock, the spending priorities of richer and poorer Euro Area Member States will not necessarily remain the same or even compatible. The role of European resources is to ensure that large infrastructure investment projects will continue despite any cross-border divergences in political pressures.

4. POLICY REMOMMENDATIONS

The European Union lacks a framework for the orderly restructuring of sovereign debt for Euro Area Member States. It is logical, therefore, that European policymakers would strive to find a common understanding of the issues that would surround the creation of such a framework. The analysis here suggests that laying the groundwork for the orderly restructuring of the sovereign debt of a Euro Area Member State will be a complex political task involving a large number of overlapping trade-offs to touch on fundamental goals and values. Fortunately, there many strong proposals available to choose from. More fortunately, those proposals converge on key features such as:

- Moving toward a single limb aggregation in collective action clauses;
- Relying on debt sustainability analyses for deciding on whether to proceed with restructuring;
- Involving both the European Commission and the European Stability Mechanism in negotiations;
- Deploying a mix of term extensions and, where necessary, principal adjustments to achieve sustainability.

There is nothing terribly surprising in these elements. Moreover, it should be feasible for European policymakers to establish a framework for balancing the risks associated with creating perverse incentives for market participants or opening the whole process of sovereign debt restructuring to political influence. The devil will be in the details of how different elements of the sovereign debt restructuring framework are put into operation. With luck, they will never have to be used.

Fortunately, European policymakers have the opportunity to make their own luck. They can do so in the first instance by avoiding the build-up up excessive imbalances – in the public sector, in the private sector, and on the balance sheets of systemically important European banks. The procedures and instruments for doing so already exist. They may be controversial and may require some fine tuning, yet the basic EU framework is there. Moreover, if these instruments – such as the policy recommendations under the European Semester, the excessive deficits procedure, the macroeconomic imbalances procedure, and the single supervisory mechanism for banks – could be made to work effectively, they could mitigate much of the need for the creation of a framework for the orderly restructuring of sovereign debt. Making them more efficient naturally also implies that there is a strong political ownership over the political cycles of the surveillance procedures both at the EU level and the national level.

Stabilisation measures are also likely to prove important, particularly with reference to periodic financial crises. If the U.S. case is any example, income stabilisation through federal taxes and transfers is less important than ensuring adequate funds to restructure banks and to protect depositors. The completion of a Single Resolution Fund and the creation of EDIS are more important than having a macroeconomic stabilisation mechanism written into a Euro Area budget line in this respect. This comparison is not to deny the political significance of institutionalized arrangements for fiscal solidarity like a budget line with explicit stabilization properties or even a reinsurance mechanism for national unemployment schemes; the concern is simply that such symbolism tends to cut both ways. Complaints about cross-border fiscal transfers are at least as apparent within national federations as they are across European Union Member States. The United States is no exception and U.S. fiscal politics is hardly something that the European Union should seek to emulate.

Where further European efforts are particularly important is in underpinning market confidence in sovereign finances and, by extension, euro area membership. Much of the basic infrastructure already exists in the form of TARGET2 as an automatic liquidity transfer mechanism. This mechanism is what release Euro Area Member States from their underlying balance of payments constraints. More work

needs to be done on the creation of a common safe asset for the euro area. Such an instrument would make it possible for financial market participants to ensure the safety of their investments without feeling the need to move their money across national boundaries. This will reduce the strain on TARGET2 and also the threat implied by a sudden loss of confidence in ability of market participants to find a buyer for their holdings of Member State sovereign debt. If European policymakers are unwilling to move toward the mutualisation of sovereign debt, then – following Gros (2018) recognition of diversified securities created in the private sector would probably be easier and more effective than creating a new synthetic structure. As noted by De Grauwe and Ji (2018), though, it is unclear whether such a move would be adequate.

European policymakers can also act to enhance the credibility of longer-term national investment projects as the Juncker Commission has done. Here there is scope for the deployment of European-level fiscal resources as has already been acknowledged in the ongoing multiannual financial framework negotiations. Such a change will not have a dramatic impact on market confidence in sovereign finances and so will not eliminate the possibility that some framework for orderly sovereign debt restructuring will be needed. Nevertheless, a European backstop for national investment projects would be a step in the direction toward underpinning national fiscal solvency and so may mitigate some of the likelihood that a Member State will need to restructure its sovereign debt.

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The purpose of this briefing note is to explore the requirements for orderly sovereign debt restructuring or the mutualisation of sovereign debt among the Euro Area Member States. The briefing has three sections. The first provides an overview of the challenges associated with restructuring sovereign debt in the euro area. The second examines the underlying need for sovereign debt restructuring and assesses how much of that need can be addressed or mitigated through the institutions for European macroeconomic governance. The third section offers policy recommendations to meet those challenges that remain. This document was provided by the Economic Governance Support Unit at the request of the Economic and Monetary Affairs Committee.

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