

PUBLIC DEBT SIZE IN THE EU AND POSSIBLE WAYS OF LOWERING IT BY RESTRUCTURING¹³

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Abstract

The debt problem in the eurozone cannot be avoided or hoped away. The article examines different opportunities of dealing with the debt burden. There are many options how to address the debt problem. Due to dramatic circumstances a number of modifications to the original rules of the SGP such as the Six-Pack, Two-Pack and Fiscal compact became politically acceptable. However, budget stabilization cannot work for a long time in the southern EU countries being permanently in recession. There are several ways how to lower the debt burden - higher inflation, various types of state bankruptcies, federalization of Europe and takeover of the debt by a common fiscal authority or an institutional solution that requires only minimal adaptation of the existing institutional structure of the EU. The latter one being a permanent "burial" of the excessive part of current debt on the balance sheet of the ECB. Under certain conditions it is possible to design this solution as non-inflationary and by exclusion of the risk of future moral hazard in public debt incensement. The main objective of the authors is to describe possible ways to reduce debt burden building on the overview of empirical and comparative analyses available in international literature. The authors come to the conclusion that new framework for dealing with debt burden will be necessary in order to eliminate persisting obstacle hindering economic growth. The most feasible solution being the one put forward by Paris and Wyplosz. Its main asset lies in the fact that the transfer of debt burden is limited to the future generations of one country. Thus the political sensitivity of higher extent of risk-sharing among eurozone countries and lack of willingness to accept bolder solutions in this respect is overcome. All alternatives mentioned in the text remain highly complex which will make it difficult for national policy makers to obtain support for

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adoption of such measures among the EU citizens at individual country level.

Keywords: Public debt, austerity, economic growth, debt restructuring

Introduction

The debt crisis in the eurozone reached a stage where some politicians talk optimistically about managing the situation by a number of institutional arrangements. The effectiveness of these measures though - whether it is the fiscal compact and the establishment of a banking union - is very controversial, just because of the particular setting of those measures. High levels of national debt would - without other measures to be simultaneously taken - greatly complicate and limit future economic growth. The aim of the following article is to explore ways how to reduce the national debt to a level that would not limit the future growth of the EU economy. This will be done by way of empirical and comparative analysis of proposals put forward so far by the experts in the international literature.

Public debt, deficits and contemporary institutional framework for debt sustainability in the EU

The fiscal rules for the EU - both fiscal criteria of the Maastricht Treaty and later the Stability and Growth Pact - have always contained a number of restrictions under which they perform their original purpose which is to preserve sound public finances in EMU. The first limitation is related to the assumptions and theories on which the value of the "right amount" limit of deficits and public debt (3%, or 60% respectively) were set arbitrarily. They were derived in the 1990th on the basis of so-called budgetary arithmetics (or debt arithmetics) for growth parameters of the EU back then and extrapolated on to the future. EU at this time consisted of 12 member states and the growing trend in the nominal rate reached 5 % per year. This use of the "debt arithmetic" approach did led to "one-size-fits-all" parametric rule in public finance. These criteria were too tight for fast growing converging economies, while for stagnating countries, on the contrary, these criteria were very loose. One can, however, argue that the simplicity and clarity of the rules are - as the theory postulates - sufficient justification for this simplified mechanistic approach in fiscal arithmetics.

Stability and Growth Pact did not only kept those rules but also added the medium term objectives which obliged the member states to achieve nearly balanced budgets in the medium term. The term of reporting about the implementation of these objectives and planning were (and are) the convergence (for countries with a derogation in the Euro adoption) and stability (for countries using the Euro) programs that the member states

periodically submit to the European Commission. Right from the start, however, the system had a large deficit in the options to enforce compliance with the rules and the enforcement of sanctions. In the wake of the introduction of the Stability and Growth Pact into practice the two key major economies - Germany and France - have failed in respecting the public budget deficit criterion. The voting system set in the Council has led to the fact that finally, in 2003, these countries were not even sanctioned by the covenant anticipated in the corrective part of the Pact. A second major limitation was therefore the enforceable compliance with these rules including the application of sanctions. At that nothing has changed, not even by a slight modification of the Pact, adopted in 2005.

The so-called debt part of the Pact – stating that overreaching the 60 % debt to GDP ratio is only possible provided that the debt to GDP ratio is approaching the reference value at a satisfactory pace – remained completely overlooked. Among the highly indebted eurozone economies only Belgium managed to reach the needed primary surpluses in the pre-crisis period. Italy has not acted that way and Greece and Portugal did not reach even positive primary surpluses. And that is more or less benevolently taken into account by other signatories of the Pact and without any reflection of the different risk of sovereign debt by financial markets.

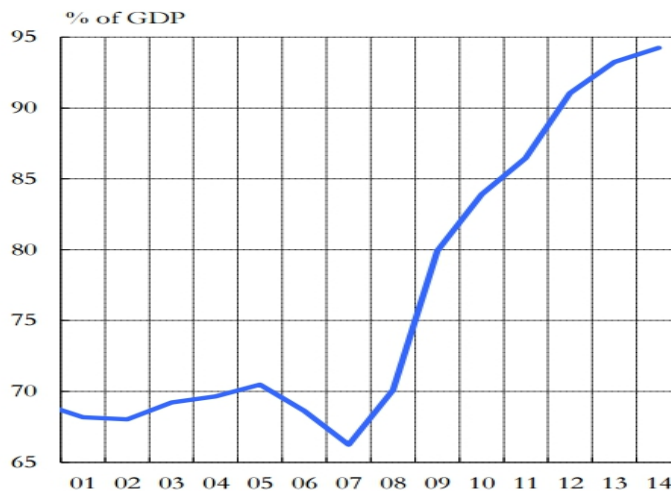
The debt crisis in the eurozone brought a number of measures which were enforced by the circumstances - in addition to the partial restructuring of Greek debt, “politically correctly” known as PSI (Private Sector Involvement), together with official assistance of Troika (Official Sector Involvement), followed by assistance to other states such as Ireland, Spain, Portugal and by extraordinary measures by the ECB pursuing stabilization of market access in bond markets for Spain, Portugal and Italy¹⁴.

Due to these dramatic circumstances a number of modifications to the original rules of the Pact such as the Six-Pack, Two-Pack and Fiscal compact became politically acceptable. (Dědek, 2013; Wawrosz, 2013). Disciplinary elements were included into the preventive branch of the Pact. Member states which do not fulfill their mid-term objectives are newly subject to additional duty of keeping prudent growth of their budget expenditures. Violation is punishable under precisely defined quantitative terms. In the corrective arm of the Pact numerical rules to reduce excessive debt were introduced; *the reverse qualified majority voting* in the Council made a very important change too.

14 Solution of the insolvency of banks in Cyprus, where by the principle of bail-in was used first will be left aside as this article focuses on the issue of sovereign debt, not the restructuring of the banking sector, although these issue are potentially closely related.

Institutional rules for fiscal policy thus became stricter and – thanks to the measures described above – their proper enforcement is more likely. In the meantime though, sovereign debts in the EU has grown to such a height that their repayment by these rules may make future economic growth impossible, see for example (De Grauwe and Ji, 2013; Wyplosz, 2012) among others. The following chart shows the development of the debt in the eurozone as a whole; its decomposition is shown in table 1:

Fig. 1: General government debt in the euro area



Source: Key indicators for the euro area, DG ECFIN July 2015

Tab. 1: General government debt in the euro area Countries

Member state	Debt/GDP 2014
BE	106.5
DE	74.7
EE	10.6
IE	109.7
EL	177.1
ES	97.7
FR	95.0
IT	132.1
CY	107.5
LV	40.0
LT	40.9
LU	23.6
MT	68.0
NL	68.8
AT	84.5
PT	130.2
SI	80.9
SK	53.6
FI	59.3
EA	94.2

Source: Key indicators for the euro area, DG ECFIN July 2015

An increase in economic growth is the only sustainable way to debt reduction. But such high debt levels, that we can see in the table, have operated through various channels to limit growth possibilities. Efforts to reduce public debt ratio through fiscal austerity have had virtually no success since austerity curtails nominal GDP growth (Malý, 2013).

Alternative ways of reducing the debt to a level not limiting economic growth

As we can see in the chart for the euro area and in the table that provides information on the level of debt in the Member States, the total debt in the euro area greatly exceeds the rate of 60 % and is approaching the 100 percentage of GDP. The problem is not present just in the countries of the southern wing of the EU but it also affects Germany and France where the debt ratio increased by approximately 20 % of GDP during the Great Recession.

Strict adherence to fiscal rules in the first seven years of the past decade might have probably helped the euro area avoid a debt crisis. However, strict compliance to the fiscal rules by the current levels of debt may lead the more indebted countries to a position similar to that of Greece which (even after the debt haircut and implementation of fiscal reforms) is generating primary budget surpluses but where its debt / GDP ratio has increased to a staggering 177% due to the decline in GDP (Zettelmeyer et al., 2013)

Economic theory and the theory of economic policy know several alternative pathways how to reduce debt to a level that would not limit economic growth. These are: (i) reduction of the relative value of debt due to higher inflation or (ii) default and debt restructuring associated not only with changes in maturity of the debt but even with partial haircut of the debt burden. As indicated in Miller and Thomas (2013) approximately 190 cases of restructuring of sovereign debt associated with the exchange of debt and its partial forgiveness can be found in the world only from 1950 to the present. The size of the haircut varies within a wide range though. Oosterlinck (Oosterlinck, 2013) reported the range of 13-78 % of the original value of the debt. The variety of ways of restructuring is actually very wide, particularly in the way of its realization. Because there is no universally accepted international bankruptcy law on public debt, each solution chosen has basically been original (Mody, 2013). For the purposes of this article, we use the subdivision proposed in the article by Miller and Thomas as a possible solution for the eurozone. These are the options: (i) creation of a comprehensive legal and institutional framework for dealing with state bankruptcy (for the euro area the European Crisis Resolution Mechanism is suggested), (ii) the purely contractual or "market driven" approach to

sovereign bankruptcy, (iii) one-time solutions for some form of a "supranational special purpose vehicle" or (iiii) combination of contracts and statutory intervention (e.g. GDP bonds or one-time solutions for some form of a "supranational special purpose vehicle"). Finally, the fifth and most challenging proposal (v) taking on the federal level and fiscal centralization has to be pointed out (the formation of common federal budget as mentioned in: Bargain at al., 2013)

As can be inferred from the current developments in the euro area the first and the fourth option seem not to be politically feasible, at least in the short or medium term.

In 2010, with the aim of securing permanent resolution framework the European Crisis Resolution Framework, so-called ECRM was discussed. Newly proposed institutional structure was supposed to resolve the issue of restructuring outstanding public debt. Concerted action of three bodies – legal (in the form of specialized chamber of the Court of Justice of the European Union in charge of legal aspects, especially litigation and formal agreement), economic (encompassing representatives of the European Commission and the ECB responsible for economic assessment) and financial (providing financial support) could according to its authors replace Paris Club discussions. (Gianviti at el., 2010) Two shortcomings of this solution are widely recognized. Firstly, its intrusiveness, secondly the non-existence of statutory priority structure, that makes it difficult to determine the order of priorities. However, during the crisis some elements of the ECRM materialized; financial institutions providing support were established as well as semi-informal set of rules for engagement of the institutions and eventually framework for liquidity support was developed. (Miller and Thomas, 2013).

In this context, it must be pointed out that existing solutions for countries with problems (especially in Greece and Cyprus) were finally - as an ad hoc response to a problem approached way too late – a combination of contractual (or market driven) solutions with "statutory intervention" when supranational institutions enforce and coordinate a way to deal with the situation when it already was "too late".

Some experts point to the fact, that so far approximately 190 debt exchanges were carried out, without the assistance of international bankruptcy court for sovereigns or international legal framework and therefore emphasize the role of the markets. (Miller and Thomas, 2013) Important substance of market driven approach are Collective Action Clauses allowing for certain quorum of bondholders to modify the payment and non-payment terms. They can also permit the aggregation across all of the sovereign's bond issuances. Hence, in case of meeting the necessary conditions, the agreement on restructuration of debt becomes binding for all

bondholders. Nevertheless the risk of holdouts is never entirely eliminated. In Greece the litigation was mitigated by repaying them in full unlike in Argentina. (Miller and Thomas, 2013).

Newly emerging options mentioned by Miller and Thomas include statutory provisions and new market initiatives. In their view the Treaty Establishing the European Stability Mechanism (the ESM) shall be amended in order to prevent seizure of the sovereign's assets receiving the ESM assistance by the holdouts that refuse to participate in the debt restructuring. (for more details see Buchheit et al., 2013) The modification of the Treaty would also oblige the ESM members to implement new legislation at national level. Even though the risk of holdouts and litigation would probably be significantly reduced, it could never be entirely excluded. (Miller and Thomas, 2013) They also mention the argument by Flandreau that other important factor is creditor coordination underpinned by institutional interventions in the market. (Flandreau, 2013 in Miller, Thomas, 2013) Another innovative solution to be combined with the previous ones proposed by the two experts being the issuance of GDP bonds that would pay back higher rate of interest, if GDP rises over certain threshold at the time of repayment or lower interest rate if the threshold is not reached (for more details see for e.g. Choi et al., 2011; Shiller, 2003). The introduction of such an instrument could be underpinned by establishment of special purpose vehicle at EU level that would buy individual country debt and issue eurobonds. Such an institution could pioneer new instrument, GDP bond, at wider level. (Miller and Thomas, 2013)

Paris and Wyplosz (2014) suggest a sophisticated, yet relatively simple way how to (hopefully) make it politically possible to create a supranational special purpose vehicle and to avoid the problem of moral hazard where less responsible governments produce excessive amounts of new debt.

This proposal is based on the assumption that it is possible to plan an orderly debt restructuring in the eurozone without any redistribution among countries. A creation of an SPV (which may be the ECB) is also a part of this proposal. This SPV would take over the existing public debt at nominal value and convert them to a zero return perpetuity. The SPV raises capital in the public markets to buy these government bonds and repays their interest. This generates a loss in the range of the interest. Seigniorage may be used to pay this loss. The main, and only, merit is that a portion of public debt is not traded any more.

„The way to eliminate politically unacceptable inter-country transfers is to require that the agency acquires and swaps public debts of all eurozone member countries in proportion to each country's share of its capital, which

determines how profits and losses are passed on to governments. This feature means that, over time, each government will ‘pay back’ the agency, over the indefinite future, the total amount – in the present value sense – of the initial debt cancellation in the form of reduced distributed profits. The debt restructuring thus amounts to a transfer of the debt burden from current to future generations within each country, without any transfer from one country to another or from current debt holders.“ (Paris and Wyplosz, 2014)

Then the crucial issue of moral hazard appears. The proposal specifies that, should a country accumulate debt again, the agency is obligated to swap the zero-interest national perpetuities back into interest-yielding bonds. Such an action which is bound to trigger strong market reactions should deter governments from sliding again into fiscal indiscipline.

What concerns the boldest step consisting in the introduction of common eurozone fiscal capacity or common federal budget, this solution is frequently mentioned in the discussion about resolution of the crisis and shortcomings of the eurozone economic governance and various suggestions have already been put forward. However, the progress in this respect remains limited mainly due to the obstacles at political level.

If we look at the first section of this article, it is obvious that solution of some form will have to be adopted in order to mitigate negative effects of high levels of public debt. In the light of the solutions that have been put forward by the experts outlined in the second section, the prospects of finding easy solution in the short run remain grim. In the medium term some combination of the above mentioned solutions will have to be put in practice. From the point of the view of the authors the solution proposed by Paris and Wyplosz seems to be of the greatest relevance as the transfer of debt burden is limited to the future generations of one country. Thus, the political sensitivity of higher extent of risk-sharing among eurozone countries and lack of willingness to accept bolder solutions in this respect is overcome.

Conclusion

Europe is suffering from a very high level of public debt, which threatens the stability of the banking sector and undermines economic growth. There are several ways how to eliminate this risk - higher inflation, various types of state bankruptcies, federalization of Europe and takeover of the debt by a common fiscal authority or an institutional solution that requires only minimal adaptation of the existing institutional structure of the EU. The latter one being a permanent "burial" of the excessive part of current debt on the balance sheet of the ECB. Under certain conditions it is possible to design this solution as non-inflationary and by exclusion of the risk of future moral hazard in public debt incensement.

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