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Managing the Sovereign Debt Crisis

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The worldwide financial and economic crisis is over and a firm upswing is underway. The economic recovery appears to be less strong though than was to be hoped for after the severe recession of 2008/09. It had cut GDP back to 2006/07-levels for many economies. As regards financial stability, some larger European banks still are operating on shaky grounds given that they have not substantially raised their capital. The situation is aggravated by the fact that quite a few of them are sitting on large positions in domestic and foreign sovereign debt. Buying this type of debt had been attractive to many banks for long, given comparatively high yields to earn plus the regulatory benefit of having no capital at all to hold against asset positions consisting of public debt.

The alleged security of sovereign debt has come into serious doubt since the outbreak of the worldwide financial crisis and more so when many governments responded to the crisis by bailing out banks and pushing up deficits. As a result, since early 2010 the financial crisis looms again, this time as a solvency crisis of sovereign debt, predominantly of south European origin. While the crisis threatens the solvency of the debt holders, banks as well as other financial institutions, it is not a euro crisis. The euro has become a world currency. It is a currency of stable internal purchasing power that would not be affected by solvency problems of any member country, let alone Greece. The fact that the external value of the euro is moving in longer swings over time is normal under the regime of flexible exchange rates, hence must not be interpreted to be a crisis phenomenon.

In this note we focus on the solvency crisis of Greece, the rescue measures taken by Greece, the EU and the ECB, and on the consequences to be drawn to avoiding similar adventures in the future.

Why Greece?

Greece is not the only European country whose sovereign debt has come into doubt since the turn of 2009/10. However, Greece was the first and hopefully only country that was confronted with the hard choice between declaring bankruptcy and asking its partners for substantial rescue measures.

A few observations may be sufficient to characterize the Greek economy.[1] Greece is one of the poorer eurozone member countries; the per capita income is below 90 percent of eurozone average. Also, the country is rather small; its share in euro-GDP is no more than 2.6 percent. The Greek export structure is dominated by services, notably transportation services and tourism. While the balance of services is in surplus year after year, the trade balance is in serious deficit and dominates the current account. The trade deficit has moved from 19 and 27 billion euros during the past decade. As a result, the current account has remained in deficit since 2000. In 2008 it reached a record high of 34.8 billion euros or almost 15 percent of GDP. The permanence of current account deficit reflects a basic weakness of the Greek economy: its development is consumption driven. Private consumption amounts to 73 percent of GDP in Greece to be compared to only 57 percent in the eurozone. Adding public consumption provides a total consumption ratio of 89 percent for Greece but no more than 77 percent for the eurozone. The excessive private propensity to consume is also reflected in an extremely low savings ratio; it amounted to no more than 0.5 percent of disposable personal income on average over the period 2000–2009.

In principle, it would have been possible for the Greek governments to consolidate budgets by enforcing higher taxation, thus curbing private spending some-

[1] Data sources used are Eurostat and the Bank of Greece.

what. But in fact, borrowing was preferred by the socialist as well as the conservative governments. To be sure, the cheap availability of credit in international capital markets after Greece's accession to the eurozone in 2001 was tempting, hence promoted the governments' lenience to easy finance. As a result, the Greek deficit exceeded the 3-percent threshold of the Stability Pact year after year with the exception of 2006 and Greece' sovereign debt level doubled in no more than ten years, reaching 273 billion euros by the end of 2009.

From hindsight, it is not too surprising that it was Greece which suddenly came under critical scrutiny by international investors as well as the rating agencies. In contrast to Portugal, Italy or Spain, Greece had become insolvent already in 2009, if not earlier, because its internal economic policies were unsustainable for long and had resulted in a current account deficit that was widening continuously. In 2009 it reached 27 billion euros or 11 percent of GDP. The real surprise is how long it took the international financial markets to detect that Greece was unable – and still is – to service and repay its external debt.

The rescue package

The risk premium on Greek debt started rising in November 2009 after a newly elected government had revised upward the reported 2009-deficit figure from 3.5 to 12.7 percent of GDP. This was a dramatic revision that was badly received on the background of widespread mistrust in the reliability of Greek statistics.[2] In a series of political negotiations that followed during the first quarter of 2010 Greece promised its partners to adopt structural and fiscal reforms. The Hellenic Stability and Growth Programme stages a three-year reform supported by the euro area member states (Euro Group) and the IMF. As regards fiscal consolidation, various types of spending cuts and measures of raising taxation shall be combined to achieve a programmed consolidation from both sides of the budget. Among the measures to be taken the following are worth noting: a reform of income taxation such that different sources of income are treated equally and all exemptions are repealed; a further increase of value-added taxation; a serious cut into the wages and bonuses paid to the civil servants; and a revision of pension law to raise the entrance age. The Euro Group responded to the Greek agenda by announcing its readiness to take measures for 'supporting financial stability and the euro'. The end of the story was that the EU put up a rescue package for Greece of 110 billion euros, to be financed jointly by the eurozone members (80 billion euros) and by the IMF (30 billion euros).

The package is supposed to guarantee financial support for three years and is conditional on Greece carrying out the domestic measures specified in accordance with the calendar set out. Table 1 differentiates the main uses of the support. The table shows that the maximal deficits accepted by the EU in March were slightly raised in May.[3] The bulk of finance, totalling 79 billion euros, will serve to permit Greece the redemption of maturing international loans, i.e. the replacement of private investors by member governments of the eurozone. Another 50 billion euros will serve as fresh money to facilitate the finance of Greece's budget deficits 2010–12. Note that the total support required may rise to even 130 billion euros instead of 110, except Greece will be able to refinance a larger part of its maturing debt. A basic assumption of the calculation presented is that the consolidation programme promised by Greece will permit cutting the deficit – that had reached 13.6 percent of GDP in 2009 – in 2010 by 5.6 percent of GDP down to 8.0 percent, to 7.6 percent in 2011, to 6.5 percent in 2012 and to 4.9 percent in 2013.

While the consolidation programme is impressive and the idea of a stronger frontloading convincing given that the sharpest cuts must always be made at the start to make an austerity programme politically viable, it is open to serious doubt that the Greek government will be able to deliver the measures as planned. The required size of the budget cuts, notably in 2010, is impressively large and potentially dangerous. The Greek Ministry of Finance expects that the Greek GDP will fall this year by 4 percent and next year by 2.6 percent but will return to growth in 2012.[4] It should be no surprise, however, if the Greek economy ends up in a more severe and longer lasting recession. If so, it will damage tax receipts and possibly require additional social expenditures. Thus there is some danger of social unrest that could slow down if not terminate the execution of the consolidation pro-

[2] In its 'Stability and Growth Programme 2000–04' the Greek government reported a deficit of 1.8 percent of GDP for the year 1999, the test year as regards admission to the euro union. The true number is conjectured to have been much higher but is unknown. Accordingly, Eurostat's data series on the deficits of member states provides a blank for the Greek deficit of 1999.

[3] See Council of the European Union, Ecofin Doc. 250, UEM 171, 7 May 2010.

[4] See Hellenic Stability and Growth Programme Newsletter, 17 May 2010.

Table 1
Checking on the size of the rescue package for Greece (in million euros)

	Total support as of		Classification of total support		
			Debt redemption	Fresh deficit as of	
	March	May		March	May
2010	37.1	34.2	15.8	21.3	18.4
2011	45.5	48.4	31.3	14.2	17.1
2012	39.1	46.6	31.7	7.4	14.9
2010–2012	121.7	129.2	78.8	42.9	50.4

Sources: Bloomberg; European Commission; own calculations.

gramme. In that case the rescue package will turn out to be too small and it is not clear at all that any euro government will be ready to contribute to another programme for Greece.

Is the package a breach of the Maastricht Treaty?

Until only recently the citizens of the EU member countries had reason to believe the long held claim of governments that they had provisioned for a strong no-bail-out clause in the Maastricht Treaty. Meanwhile, the governments have made it clear that from their point of view that was a faulty perception. Two articles of the Lisbon treaty need to be examined – Article 122 and 125.

Article 125 (1) contains indeed the famous no-bail-out principle: the EU as well as any member state "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State". Not being liable for existing commitments of any member state is an important guarantee. In fact, it is a constitutive condition for any union because it serves as a protection against the exploitation by overly indebted countries. But the no-bail-out guarantee must not be interpreted to mean that member states are not allowed to grant financial aid or loans to any member state if they so desire.

Moreover, joint financial aid by the EU may be granted in cases of emergency. The relevant Article 122 (2) states: "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the European Council may grant the financial assistance to the Member State concerned." To be sure, financial aid by the EU, not by the member states, is conditioned. It requires that the member state asking for help is troubled by 'exceptional occurrences beyond its control'.

The stipulation 'beyond its control' is open to legal interpretation. It is appropriate to differentiate the short from the long run. The sudden outbreak of a solvency crisis with risk premia jumping creates a situation that is difficult to control. At the same time, such a crisis does not happen at random but is the result of misguided policies of long standing that in principal could have been corrected if not avoided from the beginning.

No alternative to the rescue package?

Contrary to the official view held in politics there was an alternative to the plain bail-out of Greece. From a purely economic point of view, Greece could have considered to declare default and to exit from the eurozone for a couple of years. From a political point of view, however, that solution was not attractive, neither to the Greek government nor to the other European governments. The common belief was that the exit of any country from the eurozone would be taken worldwide as a signal that the euro was not a viable currency.

The declaration of default would have permitted Greece to ask for a restructuring of its sovereign debt; its level that had risen to 273.4 billion euros by the end of 2009. It seems that setting a demanding target for debt relief, a cutting by 40 percent, say, would have been a defendable aim. Such a cut would have brought the necessary relief to Greece; it would have reduced the government's annual interest burden by almost 5 billion euros or 2 percent of GDP. To be sure, the cut would have implied asset losses amounting to 20 billion euros for French, 11 billion euros for German, and 8 billion euros for Italian investors, hence a Greek default would hardly been attractive to them. The rescue package, in contrast, serves to bail out the private investors at the expense of European governments, and, should things eventually go badly, at the expense of the tax payers. In any case, the current package does not provide debt relief to Greece.

Apart from default, a pending issue is how to achieve an effective devaluation. Greece has seriously lost competitiveness during the last decade, not just with respect to tradeables but also as regards services, notably transport and tourism. Hence the Greek economy needs a significant devaluation. The planned redressing of government spending by cutting the wages paid in the public sector by 15 percent and more may somewhat contribute to reducing the general wage and price level in Greece but the degree of adjustment will hardly be a strong one. It goes without saying that the Greek government cannot order similar cuts to the wages paid in the private sector. Thus, Greece would have been better off if it still would be in command of a currency of its own; in that case it would have been possible to engineer the necessary real devaluation by means of a monetary devaluation. In principle, it would have been preferable to letting Greece exit from the eurozone for a couple of years. But in practice and to politicians the idea is a far cry from academia that must not be listened to. Whether this attitude will remain, should the rescue package fail, remains to be seen.

A new playing field for the European Central Bank ?

The debt crisis has inspired the ECB to start intervening in selected sovereign bond markets. Those bonds are used by banks as collateral to their borrowing from the ECB and a uniform quality standard was the rule. Recently, however, the ECB has started discrimination when it first decided to reduce the minimum standard for Greek government bonds, next abolished the minimum standard, and finally decided to even buy Greek bonds outright.

From a purely technical point of view this new intervention policy amounts to subsidizing Greece at the expense of the other eurozone member states. It is not obvious that the ECB is entitled to discriminatory subsidization. More importantly, the decision to buy government bonds outright is most unfortunate as it may seriously hurt the ECB's reputation as inflation fighter, at least in Germany. There it is almost common knowledge that all large inflations resulted from the monetisation of government debt by compliant central banks, notably the German hyperinflation of 1921–23. In view of this, the Deutsche Bundesbank used to emphasize the fact that it stayed away from buying government debt and so did the ECB during the early years. It seems the ECB would be well advised to return to that tradition.

Some lessons

One lesson for the EU is that it is potentially very dangerous tolerating the not playing by the rules that some member countries have become used to. Greece is the most prominent example. In only one out of the nine years since Greece became member of the eurozone the country has honoured the 3-percent deficit limit of the Stability and Growth Pact. True, Greece repeatedly deceived the European Commission, and it took a long time to find it out. Even so, the time it takes from the first observance of a too high deficit until the decision of applying a sanction is taken is generally much too long.

In fact, sanctions have never been applied because the European Council has simply avoided taking the decision. The lesson from this bad practice is that sanctions must not be politically negotiable but need to be automatic. When the deficit limit is exceeded, the sanction should be set to force without any further consideration. Only after the sanction has been initiated the Council might consider a revision provided the country in question has a valid point. Also, sanctions must be biting in the sense that a priori politicians will wish to avoid them. Financial fines make little sense because they do not hurt governments and, moreover, make the financial situation of an overly indebted country worse. A much more effective sanction might be the temporary loss of voting power in the Council. It hurts the politicians concerned directly because they lose influence and public reputation. It is conceivable that the danger of losing personal reputation will induce them to avoid violating the Stability and Growth Pact.

The most important reform to consider is negotiating a declaration on sovereign insolvency proceedings for eurozone members. The advantage of an orderly insolvency is that the country in question in one stroke gets rid of a larger part of its debt burden. This goes – as it in principle should – at the expense of investors, among them possibly larger banks of other euro union member countries. One or the other of these banks might not be able to bear the loss. If there is reason to expect that a break down of that bank endangers the stability of the payment system the respective government will have to consider stepping in by providing capital. While this is a cost to consider, in all likelihood it will become the higher, the longer an overly indebted government has the means to postpone declaring insolvency. Under conditions where this government can trust that it will

be bailed out by the euro union, it will prefer the instrument of rescue package and flatly reject the instrument of orderly debt restructuring. Consequently, to reach an agreement among the eurozone members on a declaration on sovereign insolvency proceedings the German government will have to consider taking the harsh position of indicating that it will not participate in any future rescue package if the partners reject provisions for sovereign insolvency. Should the German government not succeed, the danger is that the euro union will drift further into indebtedness and instability.

Panel

Panel 2 was chaired by **Brian M. Carney,** Editorial Page Editor of the *Wall Street Journal,* London.

A further academic introduction was given by **Giancarlo Corsetti,** Economics Professor at the European University Institute, Florence, who stressed that fiscal consolidation is now the key policy strategy for managing the crisis. As we now exit the crisis, we are left with large debt, public and private, and with low growth prospects for most of the globe. Macroeconomic stability and low interest rates must be regarded as a public good that we must pursue with our policies. Low interest rates give governments a breathing space to commit to debt consolidation, which it turn is needed for macroeconomic stability. There is a 'virtuous circle between consolidation and low interest rates'. Consolidation is the essence of the recovery. The recession we are witnessing is strange because it started from global uncertainty. Before 2007, a collapse of the financial system was completely unimaginable. With the uncertainty during the crisis, everything simply came to a halt. In this situation, fiscal stimulus worked because governments came in to reassure the private sector. Risk was the essence of the crisis, and it was shifted from the private-sector to the public-sector balance sheet. The essence of the recovery is to shift risk back to the private-sector balance sheet – it needs to invest and plan. There is of course a concern that debt restructuring could stall the recovery since it implies a drag on aggregate demand. In Corsetti's view it is a help to recovery if it is done well, as it grants macroeconomic stability. "A gradual implementation of fiscal correction can moderate the pressure on monetary policy. And the expectation of macroeconomic stability will have an enormous impact on today's stimulus, as it will translate into lower long-term rates and conditions for macroeconomic stability in the financial markets".

The first panel speaker was **Konstantinos Simitis,** former Greek Prime Minister, who spoke in favour of the issuing of Eurobonds that would serve the realisation of investments but also the financing of activities that are conducive for growth and employment. Simitis greeted the eurozone governments' declaration calling for a closer coordination of economic policies in Europe. The way out of the crisis entails moving forward towards an economic governance and political integration in Europe. Specifically with regard to the Greek crisis, Simitis observed that Greece itself is largely responsible for the present difficult situation, but simply requiring Greece to follow the rules is not the answer. "There is a north/south gap in the European Union that must be addressed". He referred to **Martin Wolf** who observed that it would not be possible for all EU states to follow Germany's example, promoting exports and discouraging domestic consumption. Simitis explained that the north/south gap in the EU is not due to character or unwillingness to work in the south but is at its core a structural problem. "I don't know the solution, but I am pointing this out because it is necessary that this be discussed". The Greek crisis itself is a symptom and we need to look at the cause. Finally, a central mechanism is necessary in the monetary union to address the problem of fiscal imbalances.

The next panel speaker, Bavarian Finance Minister, **Georg Fahrenschon,** stressed that the economic situation is not stable but that it is wrong to put all the blame on the speculators; they have the important function of identifying the problems. From the vantage point of a finance minister, it is clear that budget cuts alone are not enough. "We need policies that contribute to sustainable economic growth and the right cuts in the right places". Worldwide, there is one common financial market "and we need a regulation system, accounting standards, supervisory systems" that take this into consideration.

Jochen Sanio, President of the German Federal Financial Supervisory Authority, BaFin observed that governments have pushed themselves to the limit to rescue the financial system, "and yet we are in deep trouble again as financial institutions try to exploit this situation. Public debt has risen to such high levels that the crisis is now at a stage where speculators use the old nuclear financial weapons against individual countries. I take the liberty here to call this

shameless behaviour". This is an indication that we regulators have not done our job, and now there is no more time to lose. The much discussed regulatory tools must be adopted now and "decision-makers should not be too squeamish". The current financial system, according to Sanio, is still a playground for speculators, and one of the main problems is the credit derivatives market. Should credit derivative transactions be prohibited? The idea is appealing but it is not the panacea many believe. It would not make the financial world a safer place, as the new rules would be quickly circumvented. Sanio identified two sensible approaches. (1) The financial incentive structures must be reformed. "Checking unbridled profiteering is a key prerequisite for stabilising the financial markets in the long term". This was the real cause of the financial crisis and will spawn futures crises if nothing is done. (2) Greater transparency on the derivative markets is needed. These markets must be open and all its actors placed under strict financial supervision, including high capital requirements. It is extremely important to create stable regulatory requirements for the derivative clearing houses. We are at the cross-roads today: "people will not tolerate any longer a financial sector that generates vast profits for determined manipulators and inflicts lasting damage on millions of innocent victims".

The last panel speaker was **Theodor Weimer,** Board Spokesman at UniCredit Bank. The financial crisis has lasted much longer than initially expected and people ask themselves when the next bomb will explode. "We are living in a very serious bubble economy" with strong markets that can endanger states and even confederations. In retrospect, the financial market crisis was solidly managed. The question now is who will be the re-insurer of the states. "The problem of leverage and liquidity was fixed with even more leverage and more liquidity". Fiscal deficits have grown ten-fold on a global basis in only three years. Now, either we accept a bubble economy or we proceed down the slow and winding road of deleveraging. "If deleveraging is feasible for the banks, it should be feasible for states too".

In the discussion Hans-Werner Sinn asked why Latvia did not choose to devaluate its currency. Valdis Dombrovskis replied that the competitiveness gained from devaluation would have been short lived as there would be higher costs for imported energy and because 85 percent of Latvia's loans are in euros. It would also have led to a significant redistribution of wealth to the benefit of only a few in the society. With an internal devaluation, Latvia has been forced to make necessary structural changes. Konstantinos Simitis was also asked whether he was proposing a fiscal equalisation scheme for the euro countries. He replied that this is a problem that has not been addressed but needs to be, especially in connection with the burden sharing that already takes place in the EU. **Thomas Moutos,** professor at Athens University of Economics and Business, pointed out that the steady decline in Greece's net savings rate, which had reached minus five percent shortly before the crisis, should have been seen as an indicator of trouble ahead. There may be hope for Greece if the country can solve the problem of massive tax evasion.