Peterson Institute for International Economics

Restructuring sovereign debt – why and how to do it without endangering financial stability

Seminar on Safe Assets, Sovereign Debt, and Financial Stability

hosted by Research Institute of the Finnish Economy and the Bank of Finland, 22. January 2018

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(gratefully acknowledging influence of co-authors of CEPR policy insight 91, without implying that they agree with all aspects of this presentation)

Disclaimer

This presentation advocates changes to the euro area fiscal and financial architecture that would make sovereign debt restructuring less costly as a last resort.

It does NOT argue that the privately held debts of any euro are members are currently unsustainable and should be restructured.

Sovereign debt restructuring is proposed as an addition to the *toolkit* – not to deal with any current "stock problem".

Plan of the presentation

1. Why a sovereign debt restructuring option should be an explicit part of the euro area financial architecture
2. Why the current euro area architecture does not deliver this
3. Why standard proposals to address this – based on “hard commitment devices” – are inadequate
4. An alternative approach: reduce the ex-post costs of debt restructuring.
5. How it could be done

The rationale for sovereign debt restructuring regime for the euro area

1. Make the EU Treaty‘s no-bail-out rule credible.
    - Helps with fiscal discipline
    - Remove a source of political grief (mainly in creditor countries)
2. Avoid attempts to deal with deep solvency crises through protracted austerity + crisis lending
    - Crises of this type are rare, but they exist (Greece, 2010).
    - Such crises require debt restructuring (debt is unsustainable). Failure to recognise this has negative social and economic consequences (including redistribution).
    - Remove a source of political grief (mainly in debtor countries).

But doesn't the current area architecture already include a "debt restructuring regime"?

Sort of. But it does not work.

ESM treaty:

- Debt crises that can be resolved with a combination of adjustment and official financing: use ESM/IMF program.
- Deeper debt crises: debt restructuring using Euro-CACs.
- Tap wisdom of the IMF to distinguish between (1) and (2).

Problems:

1. Euro-CACs still give far too much power to holdouts
   - Not very different from English law bonds, only half of which were successfully restructured in Greece (2012).
2. IMF turns out not be a sufficiently strong commitment device – see Greece 2010, Greece 2015.

An obvious (?) fix: strengthen both elements!

- More serious attempt to deal with holdouts. For example ...
  1. A more powerful variant of collective action clauses („one-limb aggregation“ of bondholder votes)
  2. An amendment to the ESM treaty shielding assets of sovereigns undergoing „approved“ restructurings
  3. A treaty-based sovereign bankruptcy court (e.g. a chamber of the European Court of Justice);
- Harder commitment device. For example ...
  1. Time or volume limits on ESM use (e.g. max. of 3 years)
  2. Disallow use ESM w/o debt restructuring if debt ist „too high“
  3. Bond clauses or ESM treaty change to require an automatic debt maturity extension for recipients of an ESM programme

Some proposals including one or both of these elements

	Does proposal attempt to address	
	Hold-out problem?	Commitment problem?
Gianviti et al. (2010)	Yes	No
Gros and Mayer (2010)	No	Yes
Weder di Mauro and Zettelmeyer (2010)	No	Yes
EEAG (2011)	A bit	Yes
Weber et al. (2011)	Yes	Yes
Buchheit et al. (2013)	Yes	No
Paulus and Tirado (2013)	Yes	No
CIEPR (2013)	Yes	Yes
Fuest et al. (2014)	Yes	Yes
Corsetti et al. (2015, 2016)	Yes	Yes
Andritzky et al (2016)	Yes	Yes

Problems with hard commitment devices

1. “Type II“ errors
   - Restricting ESM-support to a country that might not have required a debt restructuring.
2. “Transition problem“
   - *Given* high sovereign debt, restricting ESM access to could trigger a new crisis.
3. How hard are these devices *really*?
   - In the face of high debt restructuring costs ex post (financial, economic and political), even seemingly “hard“ devices will not be credible. Statutes and policies can be changed. The experience with the IMF‘s exceptional access policy is a cautionary tale.

An alternative approach: our recent report

Centre for Economic Policy Research
POLICY INSIGHT No.91
January 2018

Reconciling risk sharing with market discipline: A constructive approach to euro area reform

Agnès Bénassy-Quéré, Paris School of Economics and University of Paris 1; **Markus Brunnermeier**, Princeton University; **Henrik Enderlein**, Hertie School of Governance and Jacques Delors Institute Berlin; **Emmanuel Farhi**, Harvard University; **Marcel Fratzscher**, DIW and Humboldt University Berlin; **Clemens Fuest**, Ifo Institute and University of Munich; **Pierre-Olivier Gourinchas**, University of California at Berkeley; **Philippe Martin**, Sciences Po, Paris and Conseil d'Analyse Économique; **Jean Pisani-Ferry**, Bruegel, EUI, Hertie School of Governance and Sciences Po; **Hélène Rey**, London Business School; **Isabel Schnabel**, University of Bonn and German Council of Economic Experts; **Nicolas Véron**, Bruegel and Peterson Institute for International Economics; **Beatrice Weder di Mauro**, INSEAD and University of Mainz; and **Jeromin Zettelmeyer**, Peterson Institute for International Economics[1]

Key idea: raise the credibility of debt restructuring (as a last resort) by lowering the associated financial and economic disruptions

1. Introduce “sovereign concentration charges“ that incentivize banks to invest in diversified bond portfolios
2. Offer banks a “safe asset“ (not subject to concentration charges), e.g. ESBies (senior tranches of a sovereign bond backed security).
3. Reform financial architecture to encourage euro area financial integration (European deposit (re-)insurance, capital markets union, more cross-country consistency in resolution).
4. Introduce a fiscal capacity to protect countries from large economic disruptions (e.g. unemployment reinsurance funded by experience-rated national contributions).

In addition, need to address holdout problem and strengthen commitment

To fix holdout problem:

- CACs with one-limb aggregations
- Change in ESM treaty (or a new EU regulation) protecting asset of sovereigns that have undertaken ESM-endorsed restructurings from attachment by holdouts.

To fix commitment problem:

- A more IMF-like ESM: capacity to develop ist own lending policies and stick to them; operational independence, technical capacity to identify deep insolvency crises.

Note: this would never be enough to solve commitment problem unless we reduce ex-post costs of restructuring at the same time.

Note: the "transition problem" does not magically disappear even in our approach.

Two types of "transition problems"

- Possible negative market reactions to the announcement of sovereign concentration charges and tougher ESM rules
- Market disruptions as a results of shifts in the sovereign portfolios of banks (in particular, if banks stop rolling over the debts of their own sovereign).

Need to take financial stability risks very seriously, and mitigate them.

Mitigating disruptions due to anticipation of tougher regime

1. Announce phased introduction. In particular, tougher ESM lending rules (e.g. a rule requiring maturity extensions of privately held debt when debt sustainability is uncertain) would only apply after the stock of *newly issued* debt exceeds a particularly treshold (e.g. 60-90% of GDP, Andritzky et al 2016)
2. Announce in „good times", when no markets to not expect a debt restructuring to be necessary in an any euro area country (Note: today are such times).
3. Combine with the announcement of new risk sharing and stabilization instruments (EDIS, fiscal capacity).

Mitigating disruptions due to shifts in portfolios of banks (i.e. changes in net demand for sovereign bonds)

1. Pick a regulatory approach that is penalises ***concentrated*** sovereign exposures of banks rather than ***aggregate*** holdings of euro sovereign bonds.
   - This is why we argue for concentration charges, which induce banks to diversify sovereign exposures – not necessarily to reduce them
2. Introduce a „safe asset“ based on (diversified) sovereign bond portfolio – and hence creates a demand for sovereign bonds – at the same time as banks are shedding their concentrated exposures.

Conclusion

1. To make sovereign debt restructurings feasible in deep debt crises – rather than relying on inappropriate bail-outs – the costs of these restructurings needs to be reduced

2. To achieve this, bond contracts or statutes that reduce the legal risk of sovereign debt restructuring are necessary, but not sufficient.

3. The key is to reduce the economic costs of restructuring. This requires reducing concentrated sovereign exposures of banks.

4. At a time of high debt, this is tricky. But it is feasible, by focusing on reducing *concentration*, and if better stabilization and risk-sharing tools are introduced at the same time (including a euro area safe asset and a European deposit (re-)insurance).

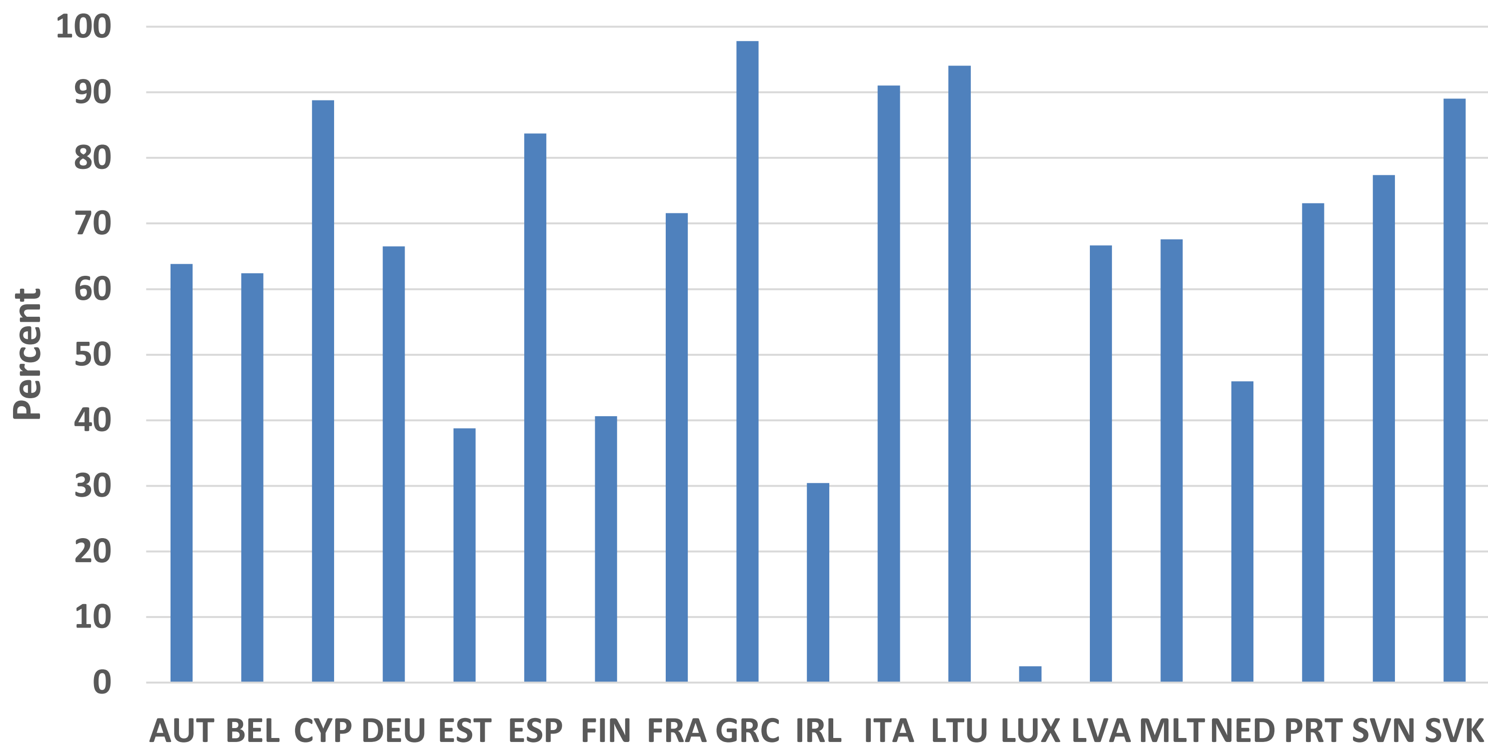
5. Once this is achieved, a more effective ESM policy not to bail out countries with unsustainable debts should also be introduced, backed by changes in the ESM's governance and mandate.

Back-up slides

Replacing sovereign bonds in bank balance sheets: how it might work

- New intermediaries begin bond buying and safe asset issuing operations,
- Euro area bank holdings of *newly issued* sovereign debt would become subject to a concentration charge. This does not apply to (1) sovereign debt issued previously; (2) safe asset.
- In each year, volume of new buying/issuing operations are calibrated to replace maturing sovereign bonds on bank balance sheets

Concentration of sovereign exposure of banks



Source: ECB and author's calculations