# Preface

The financial calamity that devastated Southern Europe over the last four years has legitimately challenged some basic assumptions of the recent economic thought and even more rightly undermined the complacency of many an economic policymaker. In the two years or so since the European Central Bank's (ECB) commitment to purchase sovereign bonds of troubled countries—the so-called Outright Monetary Transactions (OMT)—the risks for the currency union's future appear to have receded. As William R. Cline makes clear in this book, *Managing the Euro Area Debt Crisis*, there are good prospects that the longer-term fiscal aspects of the euro area crisis can be managed on an orderly basis in coming years as well. Cline makes clear that this management is a matter of could (and should), however, and not a certainty. Most importantly, Cline offers a new methodology for assessing the sustainability of government debt that will be broadly applicable to all market economies.

The euro area sovereign debt crisis discussed in this important and globally relevant volume started in early 2010 in Greece, which by early 2012 became the first industrial country since the 1930s that was forced to restructure government debt and seek deep reductions in claims by creditors. Contagion from the Greek debt crisis soon swept Ireland and Portugal, forcing them to seek official support from the IMF and European partners. Credit risk spreads on government bonds spiked to dangerous levels in the far larger economies of Italy and Spain. As of spring 2014, Ireland has successfully completed its official support program and returned to market access. Portugal is on the verge of completion of its program as well, as this book goes to press, and sovereign bond spreads have dropped significantly for Italy and Spain.

Cline's unconventional assessment of future long-run solvency for Italy and Spain is consistent with his prescient working papers published by the Peterson Institute for International Economics in February and August 2012 forecasting this stabilization, despite panic. Back then, when the crisis was still overly threatening European stability, his view was controversial. Today his independent views on debt sustainability may prove equally ahead of the curve. The biggest factor contributing to this trend, in his view, was the decision by the ECB to become an effective lender of last resort through the launching of its OMT program for purchasing government bonds if needed, subject to conditionality through adjustment programs. Cline considers maintenance of the OMT as crucial, even though so far it has not had to make any purchases.

In preparing this book, Cline drew on his extensive experience in past analyses of sovereign debt and financial crises, notably in Latin America in the 1980s (*International Debt: Systemic Risk and Policy Response*, 1984, and *International Debt Reexamined*, 1995) and in East Asia and other emerging markets in 1997–98 in his capacity as chief economist of the private sector's Institute of International Finance (while then on leave from PIIE). For this study, he has developed a new method to assess the probability distribution of future paths for the sovereign debt burden. The method goes beyond the usual enumeration of scenarios by taking account of likely correlations between good and bad scenarios for each of five key macroeconomic variables (GDP growth, primary or noninterest fiscal balance, sovereign risk spread in the interest rate, bank recapitalization costs, and privatization earnings). The resulting array of future debt trajectories and their likely probabilities enables him to diagnose whether or not the sovereign is likely to become or remain solvent. Cline's operationalization of the insight that financial crises tend to drive correlated downturns in most factors determining debt sustainability is a true breakthrough.

Cline's new method leads to original views on European debt. His model indicates that Ireland, Portugal, Italy, and Spain all show future debt paths reflecting solvency, although achieving and maintaining that solvency will require strong and persistent political will to sustain the sizable primary surpluses needed. The prospects for Greece are less sanguine. Cline concludes that, despite many strides, Greece may face continued reluctance by investors to restore its sovereign credit reputation, raising the possibility of a need for further relief from official creditors in the future.

In this rigorously analytical book, Cline considers the argument that austerity in Europe has been excessive. He judges that the Southern European economies under severe sovereign debt stress not only had zero access to large-scale private financing but also could have precipitated further widening of risk spreads if they had not shown commitment to fiscal correction. He also assesses the bank-sovereign debt "doom loop," documenting the adverse influence of sovereigns on borrowing costs of banks in Greece and Italy and vice versa in Ireland and Spain. He concludes that interest rate shocks from sovereigns to banks were not fully passed on to private sector borrowers, but instead financial fragmentation arose partly in the form of severe credit rationing. Cline further assesses the effectiveness of some potential European institutional innovations to deal with the crisis and analyzes the possibility of introducing eurobonds in the future.

We at the Peterson Institute are proud to have made important ongoing contributions to the policy debate on how to resolve the euro area debt crisis. In June 2009, Nicolas Véron and I published "A Solution for Europe's Banking Problem," a Policy Brief that set out a vision for unified bank supervision and regulation in Europe, one now coming to fruition in the Single Supervisory Mechanism. From 2010 through early 2014, PIIE published two dozen Policy Briefs and Working Papers on the crisis as well as a conference volume on policy options in March 2012 (*Resolving the European Debt Crisis*, Special Report 21, ed. Cline and Guntram Wolff). The Institute has been the leading US forum for serious discussion of euro issues. We hosted speeches and discussions on the issues by euro area finance ministers, central bank board governors and members, EU commissioners, two ECB presidents, and three heads of state. Several senior members of the Institute staff—notably Anders Åslund, C. Fred Bergsten, Jacob Kirkegaard, Angel Ubide, and Nicolas Véron in addition to Cline—have provided widely followed commentary on the crisis as it has evolved. In tandem with this book, PIIE is publishing an analytical insider's account of the crisis by Simeon Djankov, finance minister of Bulgaria from 2009 to 2013, titled *Inside the Euro Crisis: An Eyewitness Account*.

The Peterson Institute for International Economics is a private, nonprofit institution for rigorous, intellectually open, and honest study and discussion of international economic policy. Its purpose is to identify and analyze important issues to making globalization beneficial and sustainable for the people of the United States and the world and then to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute's work is funded by a highly diverse group of philanthropic foundations, private corporations, and interested individuals, as well as income on its capital fund. About 35 percent of the Institute's resources in our latest fiscal year were provided by contributors from outside the United States. Interested readers may access the data underlying Institute books by searching titles at http://bookstore.piie.com.

The Executive Committee of the Institute's Board of Directors bears overall responsibility for the Institute's direction, gives general guidance and approval to its research program, and evaluates its performance in pursuit of its mission. The Institute's President is responsible for the identification of topics that are likely to become important over the medium term (one to three years) that should be addressed by Institute scholars. This rolling agenda is set in close consultation with the Institute's research staff, Board of Directors, and other stakeholders.

The President makes the final decision to publish any individual Institute study, following independent internal and external review of the work.

The Institute hopes that its research and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

Adam S. Posen
President
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