

Managing Deep Debt Crises in the Euro Area: Towards a Feasible Regime

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Abstract

In spite of the inclusion of collective action clauses (“euro-CACs”) in euro area sovereign bond contracts since 2013, the euro area still does not have a credible debt restructuring framework because (1) stability risks of debt restructurings remain high; (2) euro-CACs make it easy for creditors to hold out for full repayment; (3) IMF lending policies have not prevented the bail-out of countries with unsustainable debts. In reaction, some proposals have called for hard criteria requiring debt restructuring as a condition for access to official crisis lending. This paper argues that this is the wrong approach, because hard criteria are error-prone, may trigger crises in high-debt countries, and lack credibility when the economic costs of debt restructurings are high. Instead, the key to a credible debt restructuring framework is to reduce these costs, by cutting the links between sovereigns and banks and putting safety nets in place that limit contagion.

For most advanced countries, 2010 was the year in which the global financial crisis was overcome – with growth resuming much more quickly than had been expected even in late 2009.² For Europe, it was the year in which the global financial crisis morphed into the Euro area debt crisis. As the crisis unfolded in Greece and spilled over to Ireland and other “peripheral” European countries, 2010 brought three main realizations. First, the financial architecture of the Maastricht treaty, which assigned responsibility for stable government finances to the Stability and Growth Pact (SGP), had a gaping hole: poorly supervised financial systems and cross-border flow, leading to excessive *private* debt accumulation, which could

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² Although both the 2009 Spring and Fall editions of the IMF’s World Economic Outlook got the 2009 output decline in advanced countries almost exactly right (about -3.5%), they greatly underestimated growth in 2010, which was forecast at 0 and 1.3%, respectively, but turned out to be over 3%.

turn into a government debt problem. Second, the SGP had not even attained its narrow objective, namely, to keep *public* debt low and manageable. It had not prevented persistent fiscal deficits debts in several countries, notably Greece, and provided insufficient incentives for accumulating fiscal buffers in many others. Third, the Euro area lacked any instruments to deal with debt crises, perhaps because such crises were never meant to happen. Now that they were happening, these instruments needed to be invented in a rush.

Over the next four years, Euro area policy makers reacted to these problems – sometimes imperfectly and haphazardly, but react they did. The reaction involved three elements: revamped rules and surveillance procedures aimed at influencing economic policies of EU members directly; new European institutions focused on both crisis prevention and crisis management; and legal changes aimed at extending private sector burden sharing in a crisis and thereby strengthening market discipline. With respect to crises related to private debt and external imbalances, this led to the creation of the European Systemic Risk Board (2010), the Macroeconomic Imbalance Procedure (2011), the Single Supervisory Mechanism and Single Resolution Mechanisms (2014-2015) and the EU Bank Recovery and Resolution Directive (2014), which forces some private creditors to share the losses of bank resolution. With respect to sovereign debt crises, steps included reforms of the SGP (2011), the creation of the European Stability Mechanism (ESM, 2012), and beginning in 2013, “collective action clauses” in Euro area sovereign bonds, which allow the restructuring of bond contracts with the agreement of a qualified majority of bond holders. As in the case of the BRRD “bail-in” rules, these were intended to provide the legal underpinnings for private sector burden sharing, should this become necessary, and thereby strengthen market discipline.

The present paper focuses on the attempt to create a regime for managing sovereign debt crises in the Euro area that allows private sector burden sharing if necessary. It serves three purposes. First, it explains why the status quo does not live up to its aims – namely, to provide a reliable alternative to ESM bailouts when countries are deeply insolvent and thus to strengthen market discipline. Second, it summarizes policy proposals that attempt to address this, centred on legal changes but also (and particularly) on stronger commitment devices to prevent inappropriate ESM bailouts. It argues that these commitment devices raise problems that make them inherently difficult to adopt – and that they are hence unlikely to ever be adopted. Third, it proposes an alternative approach that would allow orderly sovereign debt restructuring in the Euro area.

The main idea underlying the proposal is to focus less on rules and commitment devices and instead undertake reforms that would reduce the adverse economic spillovers of sovereign debt restructuring. In addition, the Euro area will need legal changes to address the creditor collective action problem as well as policies to manage the uncertainty about whether debt

restructurings are ultimately required or not. The combination of all three aspects would, finally, create a feasible regime for managing deep debt crises in the Euro area.

The Euro area's current "debt restructuring regime"

Sovereign debt restructurings are often "too little, too late" (IMF 2013, CIEPR 2013). An example for this is the famous 2012 Greek debt restructuring. It came too late: implementing it in mid-2011 for example, when the extent of Greece's insolvency was amply clear, would have saved the Greek and/or European taxpayer about €10 billion (Zettelmeyer et al 2013). It was too little: although it led to a transfer of around €100 billion Euros from private creditors to Greece, and notwithstanding significant adjustment and reform efforts in the meantime, it turned out to be insufficient to restore Greece to solvency. As of early 2018, a further deep restructuring looks inevitable, this time at the expense of official creditors (Zettelmeyer et al 2017a, b).

There are several reasons for this phenomenon. Some have to do with the legal risks of sovereign debt restructurings. A specific risk is the fact that a restructuring agreed with most creditors may be challenged by "holdouts" refusing to take part in the restructuring. The sovereign is then faced with the difficult choice. It can refuse to pay the holdouts, which may lead to protracted legal battles and restrict its ability to issue debt internationally, and possibly even to service its existing debts. Or it can repay them, which reduces debt relief (Greece chose the latter).

The option of "holding out" also gives some creditors additional bargaining power, which can make it tougher to achieve a deal restoring debt sustainability. In emerging market countries, sovereigns and their lawyers have developed techniques to deal with holdouts (Bi et al 2016), but these techniques often require aggressive actions which governments that want to maintain good reputations may find unpalatable, and that may make the country vulnerable to challenge (as in the case of Argentina's court saga, which began in 2005 and was resolved only in 2016).

Beyond the legal risks, the reluctance of governments to face debt crises by restructuring their debts likely reflects much deeper political and economic problems. Some have to do with the distributional consequences of sovereign defaults on the one hand and attempts to avert defaults through fiscal adjustment on the other. Defaults may hurt the elites more than the average taxpayer, while the opposite tends to be true for attempts to restore fiscal solvency through protracted periods of austerity. For example, there is some evidence that sovereign defaults sharply increase the likelihood of political turnover (i.e. a drop in support for the ruling

party or coalition, or a change in government).³ Even when domestic redistribution is not an issue, policy makers will tend to resist defaults because of their economic costs for the country as a whole – particularly their impact on the domestic financial sector, which is often highly exposed through sovereign bonds held in banks and pension funds.

Importantly, high ex-post costs of default – whether from the perspective of a political incumbent, or the country as a whole – can give rise to a time consistency problem. Before a debt crisis develops, a tough approach to managing debt crises, which requires creditors to bear some losses, could be optimal because of its disciplining implications. Private creditors that bear the risks of reckless borrowing and lending are less likely to extend credits to countries that may not be able to repay. This leads to less accumulation of potential bad debts in the financial system, and earlier corrective action (potentially with the support of international crisis lenders such as the IMF or ESM).

Once a crisis erupts, however, these costs are “sunk”. What matters at that point is to minimize the cost of the crisis – for the real economy, for the incumbent politicians, and for other countries whose voices may matter. At that point, a bailout may seem (and often be, even in a broad welfare sense) the cost-minimizing way out. As a result, private sector burden-sharing will not happen. Anticipating this, private creditors will offer cheap and plentiful access to debt finance, and countries may overborrow – to the detriment of the domestic taxpayer whose obligation it is to repay these debts, the international taxpayer who bears the risks of a bailout, or indeed both.

For these reasons, proposals for creating an international financial architecture that involves credible private sector burden sharing have typically called for reform in two areas. First, legal frameworks – by statute or embedded in bond contracts - that would address the holdout problem. Second, policies or rules that constrain international crisis lending unless this is either very likely to restore debt sustainability by itself or is accompanied by a debt restructuring.

The current sovereign debt crisis management framework in the Euro area, enshrined in the February 2012 ESM treaty, can be interpreted as one such attempt:

1. To address the holdout problem, the treaty committed the Euro area countries to include a standardized collective action clause (the “Euro-CAC”, see Gelpern and Gulati

³ See Borensztein and Panizza (2009), Livshits et al (2014).

2013) in all bond issues after 2012. This clause permits a restructuring of the payment terms of the bond with the agreement of a qualified majority of creditors.⁴

2. As a precondition for crisis lending, the ESM treaty requires the European Commission to assess whether public debt is sustainable, “wherever appropriate and possible ... together with the IMF.” Furthermore, the treaty preamble states that “a euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF”.⁵ Hence, co-lending with the IMF – which in turn is assumed to have policies committing it not to bail out countries with unsustainable debts – in effect plays the role of a commitment device.

However, as the experience since 2012 has shown, neither of these devices is likely to be very effective.

- While “Euro-CACs” have never been tested, the experience with very similar (English law) CACs in the 2012 Greek restructuring has not been encouraging. Among 35 English law bonds, only 17 were restructured. In the remaining 18 cases, holdouts succeeded in blocking the exchange (Zettelmeyer et al 2013). These holdouts have since been repaid in full – setting a precedent that holdout strategies can work in Europe, and hence increasing the likelihood that such strategies would again be tried in any future Euro area restructuring.⁶
- The use of the IMF as an “anchor” has by now failed twice in Europe – arguably, in every instance in which the anchor became binding (Weder di Mauro and Zettelmeyer 2017). In 2010, the IMF’s “exceptional access policy” prohibited large-scale crisis lending to countries unless their debt were sustainable with high probability - a condition that Greece did not meet. To enable co-lending with the Europeans, the IMF changed its

⁴ The required threshold is usually agreement of vote-casting creditors holding at least 75% of the face value of each individual bond. This threshold declines to 66.67 percent if the debt restructuring is supported by creditors holding at least 75% of the face value of *all* bonds.

⁵ The quotes are from the ESM treaty, see https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf, Article 12.3 and Treaty Preamble 8.

⁶ As a last resort, the option of using the local legislature to implement a class voting mechanism across the entire stock of locally issued sovereign bonds remains on the table (see Buchheit and Gulati, this volume). This option was pivotal to the success of the 2012 Greek bond exchange (Zettelmeyer et al 2013). However, substantial stocks of government debt in Italy, Portugal, Spain, Greece and other Euro countries were issued under foreign law, and most of these countries continue to issue under foreign law. Furthermore, the fact that local law bonds issued after 2012 now carry CACs make it more likely that restructurings based on acts of the local legislature will be subject to legal challenge.

policy to carve out an exception. A few years later, when the IMF signalled, in June 2015, that it considered Greece's debt unsustainable to the point that it would not participate in a new program, the ESM went ahead without IMF participation.

This is not to argue that the expectation that the IMF will participate in ESM-financed programs is entirely without bite. For example, the ongoing ESM program with Greece was renegotiated in 2017 to allow IMF participation in principle. However, the IMF's assessment that Greece's debt was (and continues to be) unsustainable has not prevented the Euro area countries from lending to Greece. This shows that commitment devices of this nature risk being circumvented when the political or economic pressures to bail out become too large.

Proposals for a more ambitious sovereign debt restructuring regime⁷

Not surprisingly, calls for a more ambitious European debt restructuring regime have focused on the two most apparent weaknesses of the present regime: its likely inability to effectively deal with holdouts, and its lack of a hard device committing the ESM not to bail out countries with unsustainable debts. Proposals to address these weaknesses can be summarized as follows.

Dealing with holdouts. Some authors argue for a full-fledged, treaty-based legal procedure resembling corporate bankruptcy, involving a sovereign bankruptcy court (for example, a chamber of the European Court of Justice). Decisions of that court would be binding for all creditors (Gianviti et al. 2010, Paulus and Tirado 2013). A little less ambitiously, Lee Buchheit, Mitu Gulati and Ignacio Tirado (2013) — and following them, CIEPR (2013); Clemens Fuest, Friedrich Heinemann and Christoph Schröder (2014) and Giancarlo Corsetti et al. (2015) — proposed a change to the ESM treaty that would extend immunity from judicial process to sovereigns whose debt restructuring has been negotiated in the context of an ESM program and/or agreed by a (super)majority of creditors. Finally, several authors argue for CACs that allow “one-limb aggregation” of bondholders, an approach proposed by the International Capital Markets Association in 2014 and advocated by the IMF for some time (Gelpern, 2014; IMF 2003, 2014). CACs of this type would no longer require the consent of a qualified majority of the holders of each bond that is to be restructured, replacing this with the consent of a qualified majority of *all* bondholders (Gelpern 2014, IMF 2014). This would make it much harder for holdouts to acquire a stake that could block a restructuring.

⁷ This subsection draws in part on Weder di Mauro and Zettelmeyer (2017).

Commitment devices limiting the use of the ESM could take the form of time or volume limits to ESM support (for example, a maximum of three years, or a maximum of 60 percent of GDP, see EEAG 2011, Fuest, Heinemann and Schröder 2014 and Gros and Mayer 2010). Alternatively, ESM support (or at least large-scale ESM support, or ESM support without an accompanying maturity extension) could incorporate explicit *ex ante* conditionality, that is, be open only to countries that have good policy track records, and/or remain below certain debt levels (Weder di Mauro and Zettelmeyer 2010, CIEPR 2013, Corsetti et al. 2015; Andritzky et al. 2016). Risks to official creditor and the taxpayers that back them can also be mitigated by bond clauses requiring a maturity extension if a country becomes a recipient of an ESM loan, exceeds a certain level of debt to GDP, or a combination of both (Weber, Ulbrich and Wendorff 2011; Fuest, Heinemann and Schröder 2015). The same idea could also be implemented via a change of the ESM treaty that requires such maturity extensions under some conditions (Corsetti et al. 2015, 2016, Andritzky et al. 2016).

With respect to the first bucket, the controversial question is not whether the legal framework ought to be extended to better address the holdout problem – the IMF, industry associations such as ICMA and all authors in this literature agree that it should – but how to go about this. In this respect, there are some straightforward trade-offs between the main proposals. Replacing “Euro-CACs” by ICMA-standard CACs in Euro area sovereign debt would make it less likely that holders of these bonds could block a restructuring, and subsequently protect the assets of the restructuring sovereign from holdout claims anywhere in the world. But they would help only with respect to claims of the holders of the (new) bonds that carry these clauses – not with the entire existing stock. Moreover, they change is likely to be resisted by debt managers who have only recently, and reluctantly, signed up to Euro-CACs (Gelpern et al 2017).

In contrast, the Buchheit et al (2013) proposal would protect sovereigns from claims by *any* holdout – regardless of the vintage and governing law of the bond contract – but only inside the territory of the signatories of the ESM treaty (the Euro area). Finally, more elaborate bankruptcy-tribunal type proposals would shield assets outside as well as inside the Euro area, and do so with respect to claims based both on new and old vintages -- but only for bonds issued under the governing law of a Euro area country. Beyond this, the impact of such a more elaborate procedure would depend on exactly the role of the tribunal is specified – for example, whether it is limited to certifying that certain procedural criteria have been met, or whether it is asked to take a view on the substantive merits of a debt restructuring plan.

Proposals in the second bucket – hard criteria that would prevent the ESM from extending assistance in high-debt cases or would require some form of restructuring as a condition – are much more controversial. There are three main reasons for this.

First, while hard commitment devices obviously reduce the risk that ESM will lend to unsustainable debt cases without an appropriate debt restructuring (“Type I error”), they create a new risk: namely, to deny financing to countries that could have restored their solvency, without a debt restructuring, by undertaking adjustment and reform inside and ESM program (“Type II error”). Proposals differ in their efficiency with which they trade off the two types of errors: the worst could create a large Type II error without reducing the Type I error very much, the best do a lot to reduce the Type I error and keep the Type II error manageable. But a Type II error always exists.

Second, introducing hard commitment devices at times when debt is already very high may well be counterproductive. Such times are “ex ante” in the sense that they precede a potential new crisis, but “ex post” in the sense that most of the macroeconomic and fiscal management decisions that determine crisis risks have already been taken. As a result, the beneficial effect of a tough commitment device via better policies is small, and likely to be swamped by the adverse direct effects, on country risk and yields, of curtailing the ESM’s ability to help a country that suffers a loss of confidence. Indeed, a change in official policy leading to expectations of greater private sector burden sharing may itself lead to a loss in confidence, with catastrophic effects in vulnerable countries. Europe experienced this when the results of the “Deauville beach walk” of German Chancellor Angela Merkel and French President Nicolas Sarkozy – a compromise at which the French and German leaders agreed both to the creation of the ESM and the general principle of private sector involvement – hit bond markets in October 2010, contributing to the spread of the euro crisis.⁸

Some of the authors proposing hard commitment devices recognize this risk and offer solutions. For example, the commitment could take the form of a rule or policy that becomes effective only after a long transition period, giving countries time to adjust. But transition plans of this sort create their own problems. If the plan creates too much discipline in the short run, it will precipitate a crisis. But if it creates too little, the country may not use the transition period to undertake the needed adjustment. In that case, the end of the supposed transition period will likely precipitate the crisis that the transition period intended to avoid, which imparts a strong incentive to postpone it. Without a credible deadline, the requisite adjustment may never happen. The bottom line is that ensuring both the safety and the effectiveness of a

⁸ Specifically, Merkel and Sarkozy agreed to establish “a permanent and robust mechanism to ensure orderly crisis management in the future, which includes the necessary arrangements for adequate private sector involvement.” See Brunnermeier et al (2016) and Weder di Mauro and Zettelmeyer (2017) for details.

transition plan requires getting the balance between discipline and (continuing) insurance just right. This is not very reassuring.

Third, and most importantly: commitment devices only work if they are credible. In a crisis, however, the pressures to bail out a country even when this violates a supposedly “hard” device may be enormous. As argued above, one of the motivations for the ongoing search for “hard” commitment devices is the fact that the existing device – co-lending with the IMF – proved to be no match for the pressures that Greece and the Euro area experienced in both 2010 and 2015. But it is not clear that the devices proposed by the literature, both statutory and contractual, would have fared much better. A statute can always be changed. And even devices hard-wired into bond contracts could be overruled by new statutes for bonds issued under local law, which are in the majority in the Euro area, or by offering a bond exchange that eliminates the contractual commitment device.

For these reasons, introducing hard commitment devices preventing bailouts of overindebted countries is risky, likely to face heavy opposition, and may ultimately not solve the underlying problem. A better approach may be to tackle the underlying problem that drives the demand for commitment devices in the first place: the exorbitant economic cost of debt restructuring in the euro area. Reducing that problem may not fully eliminate the need for commitment devices. But it will greatly increase the chances that commitment devices – including devices that are not entirely “hard” in the sense that they allow some room for discretion – succeed in delivering effective commitment.

An example for such a commitment device is the IMF’s Exceptional Access Policy, which prohibits large-scale crisis lending to countries whose debts are not sustainable with high probability unless specific conditions are met, such as a “reprofiling” (maturity extension) of existing debts to the private sector (IMF 2016a,b; Schadler 2016). Policies of this type, which allow some discretion in deciding what “not sustainable with high probability” means exactly, are typically ineffective when ex post crisis costs are very large, because discretion creates loopholes that can be exploited to get out of the commitment. But exploiting these loopholes is not without (political or reputational) cost. When the ex post economic costs of following the spirit of the policy appears to be manageable, even commitment devices that allow discretion could have meaningful ex ante effects.

At the same time, allowing room for discretion will greatly reduce the chance of committing a Type II error -- forcing a restructuring when none is needed – because it permits the consideration of all relevant information at the time when the decision has to be made. This is not the case with hard devices, in which the criteria for allowing crisis lending and the information used to determine if the criteria have been met need to be specified in advance.

Reducing the economic costs of debt restructuring

Reducing costs for the restructuring country

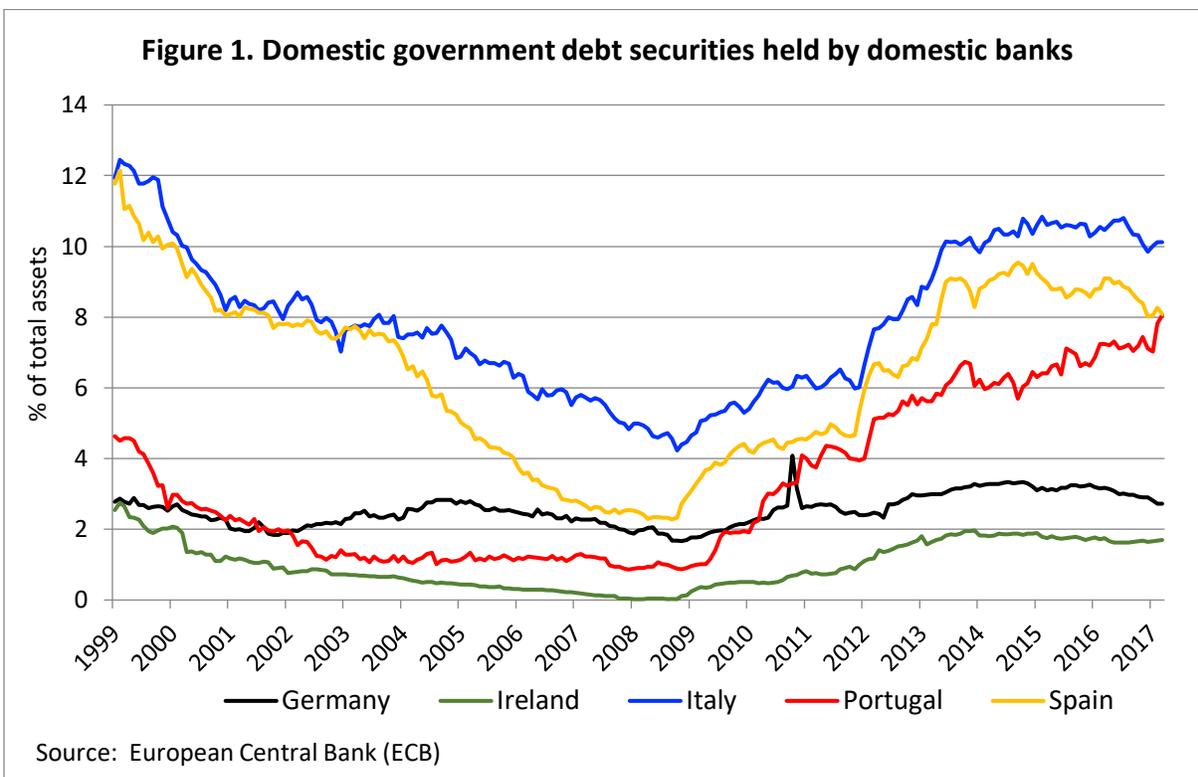
Defaults and debt restructurings have reputational costs, which result in temporarily higher costs of borrowing after sovereigns have restructured their debts (Cruces and Trebesch 2014). For the most part, however, the economic costs of defaults and restructurings are related to the close links between the sovereign and the domestic financial system. The most important direct link is a typically high exposure of banks to their sovereigns, in the form of bank holdings of sovereign debt. This guarantees that any restructuring of debt obligations that strongly reduces the net present value of claims on the sovereign will instantly translate into a solvency problem for the banks holding these claims. Anticipating this, impending sovereign debt troubles can lead to runs on banks and capital flight. The result is a collapse in investment, which leads to a recession that further weakens government finances. This loop from weak government finances to banking crises and back has been referred to as the “bank-sovereign-doomloop”. It has been a hallmark of the Euro area crisis (Pisani-Ferry, 2014),⁹ but was previously well known from emerging market crises (Sturzenegger and Zettelmeyer 2007, Panizza et al 2009).

In the 2012 Greek restructuring and in many previous debt restructurings in emerging markets, the impact of sovereign debt restructuring on the balance sheet of domestic banks was mitigated ex post by recapitalising domestic banks immediately after the restructuring, in effect recycling a portion of the pool of resources transferred from external creditors to the domestic financial system (Zettelmeyer et al 2013, Sturzenegger and Zettelmeyer 2007). As a result, domestic banks in effect enjoy a partial guarantee on the debt holdings of their own sovereigns: as long as they are systemic and hold a sufficiently large share of sovereign debt, the sovereign will be forced to compensate them for losses that would otherwise trigger a collapse.

Reflecting this, the Euro area crisis triggered a “repatriation” of sovereign debt to the domestic banking systems of countries such as Italy, Portugal and Spain (Battistini et al 2014 and Brutti and Sauré 2016), as illustrated in Figure 1. In these countries, and several others, bond of the home country sovereign are now back to 8-10 percent of total banking assets. This implies that a sovereign debt crisis in these countries, and a debt restructuring if this were to become inevitable, would have a large negative impact on the domestic banking system and

⁹ In the Euro area crisis, the trigger for the “doomloop” was for the most part a banking crisis, which spilled over to the sovereign due to both recession-induced deficits and the need to recapitalise the banks. The remaining elements of the doomloop operated as described above.

consequently on the economy. It also makes debt restructurings increasingly ineffective as a last-resort tool for resolving debt crises, as an increasing share of the transfers from private creditors to the sovereign will have to be used to rescue the domestic banking system.



Reducing the damage of sovereign debt troubles on the economy – and to making sovereign debt restructurings feasible as a last resort – hence requires protecting the financial system from the consequences of sovereign default. Two reforms of the euro area financial architecture would go a long way toward achieving this.

First, a euro-area wide change in regulation that prevents banks from holding concentrated exposures to their domestic sovereign. In particular, Euro area banks holding sovereign exposures to any euro area country in excess of a given threshold – say, one third of their tier-one capital – could be compelled to hold additional capital (Véron 2017). A concentration-based regulation of this type would have much more limited distributional effects than risk based capital charges, since the latter would penalize banks currently holding lower-rated sovereign bonds while benefiting banks holding higher rated bonds. It would also avoid regulatory incentives to reduce lending or raise capital when sovereign are downgraded, which can exacerbate the impact of a sovereign debt crisis.

Second, the introduction of a European deposit insurance system (EDIS). This would give depositors comfort that their deposits are protected even if the domestic sovereign is forced to

restructure its debts, reducing deposit flight and capital flight, and hence liquidity strains in the banking system. In spite of being part of the “road map” for banking union agreed by the euro area in 2012, EDIS has been on hold because of the reluctance of countries such as Germany, the Netherlands and Finland to agree to deposit insurance proposals that fully mutualize risk. However, it would be possible to design EDIS in a way that avoids full risk mutualization – through a structure in which “compartments” fed by national contributions insure against the first losses of a national banking crisis, while a mutual fund provides a backstop in the event of catastrophic crises (Bénassy-Quéré et al 2018, Schnabel and Véron 2018).

Reducing costs for the other euro area countries – limiting contagion

The two proposals outlined above – sovereign concentration charges and EDIS – would help to protect not only the crisis country but also other euro area members from the consequences of a sovereign debt restructuring, by avoiding a depositor panic and by limiting the impact of the restructuring on the balance sheet of banks. This said, incentivising banks to hold diversified portfolios of euro area bonds rather than being primarily exposed to their own sovereigns could also create a new channel of contagion, as the consequences of a default in a specific country would hurt banks throughout the euro area.

To avoid this problem, the gradual imposition of sovereign concentration charges could be accompanied by the creation of a euro area safe asset, which would be free from regulatory charges, and could gradually replace direct holdings of sovereign bonds by banks. Proposals to create such a safe asset include “Eurobonds” guaranteed by member states, debt issued by a euro area budget, and debt issued by financial intermediaries holding diversified portfolios of sovereign bonds, without member state guarantees. Box 1 briefly describes these proposals.

Finally, limiting the spillovers of sovereign debt restructurings in the euro area requires effective protection of “innocent bystanders” from potential contagion, by ensuring that they are able to maintain market access, and possibly through a fiscal insurance mechanism. The former could consist in short- to medium term access to ESM liquidity for pre-qualified countries (for example, countries, that have been given a clean bill of health in the annual EU fiscal and macroeconomic surveillance process), with no or minimal conditionality ex post. The latter could take the form of a “rainy day fund” fed by members contributions designed to provide budgetary support (transfers, not loans) to countries subject to a large negative employment or output shock (Bénassy-Quéré et al 2018). Moral hazard could be avoided by limiting access to the fund to countries that comply with euro area fiscal rules and meet minimum standards under the Macroeconomic Imbalance Procedure, through a “reinsurance” structure in which shocks would trigger payouts only to the extent that they exceed a threshold, and by differentiating payments into the fund based on the volatility of the variable

that would trigger the payment, so that countries that are more likely to receive payments make larger contributions.

Box 1. Options for creating euro area “safe assets”

Euro area debt securities with low expected loss rates – comparable to those of AAA-rated bonds – could be through one or several of the following four ingredients: (1) member state guarantees, (2) common but limited fiscal resources (for example, to capitalize a financial intermediary), (3) legal seniority, and (4) diversification, as follows.

1. A European authority could issue a “Eurobond” jointly and severally guaranteed by member states (De Grauwe and Moesen 2009, Bonnefoy 2010). Alternatively, a portion of the sovereign debt of member states (for example, up to 60 percent of GDP) could be jointly and severally guaranteed (Delpla and von Weizsäcker 2010, 2011). In the event of a debt restructuring, the guaranteed bonds could enjoy legal seniority, limiting the risk assumed by the euro area (as well as potential moral hazard, since the seniority of the guaranteed portion of national debt would raise the costs of the subordinated, non-guaranteed portion for high debt countries).
2. A Euro area budget could issue its own debt, financed either by a dedicated revenue stream (such as a euro area corporate tax or a VAT) or by firmly committed member state contributions (Ubide 2015).
3. Euro area members could capitalize a public financial intermediary which issues debt and invests the proceeds either in euro area sovereign bonds or an internationally diversified portfolio of assets (in effect, operating as a leveraged sovereign wealth fund). By choosing the capital level conservatively, the debt issued by the intermediary could be made as safe as the German bund. Using Monte Carlo simulations, Zettelmeyer and Leandro (2018) show that if the intermediary only invests in cash and a portfolio of euro area sovereign bonds that roughly emulates the ECB capital key, this would require a capitalization level of 24-29 percent of the debt issued.
4. Euro area members could create a public financial intermediary that is legally senior, buys a diversified portfolio of euro area loans at face value, and issues bonds (following Monti, 2010, this is sometimes referred to as the “E-bond” proposal). Legal seniority could be established either through statute or by contractually subordinating future euro area sovereign bonds to debt claims held by the intermediary. The intermediary would charge all borrowers a uniform interest rate equal to its average funding costs (similar to what the ESM does today). To ensure that the debt issued by the intermediary performs even in a crisis that triggers a loss-given-default exceeding the stock of subordinated bonds, the intermediary could be capitalized. Zettelmeyer and Leandro (2018) show that the required capital would be much smaller than in the case of an intermediary that does not enjoy seniority (about 2 percent of assets).
5. Euro area authorities could create a regulatory and supervisory framework that would allow competitive private financial intermediaries to issue multi-tranche (e.g. senior, mezzanine, and equity) debt securities backed by diversified portfolios of euro area sovereign bonds (“sovereign bond backed securities”, see ESRB HLTF 2018). The senior tranche, which the authors of the

proposal call “European senior bonds” (ESBies, see Brunnermeier et al 2011, 2017) could play the role of a safe asset. Using Monte Carlo simulations, Brunnermeier et al 2017 show that the junior tranches would need to comprise about 30 percent of the face value of the debt securities issued in order to make the five-year expected loss rate of the senior tranche about as low as that of a German bund.

These options differ widely with respect to the fiscal costs and risks they pose for the member countries, incentive effects, distributional effects, and the costs of issuing bonds into the market (see Leandro and Zettelmeyer, 2018 for details). Joint and several guarantees would pose the biggest potential liability. The resource implications of debt issued through a euro area budget would more limited, since members may only need to commit to a small revenue stream. For example, sustaining a debt stock in the order of 25 percent of GDP – more than enough to replace the entire stock of euro area sovereign debt held by euro area banks – would require a primary surplus of about 0.2-0.3 percent of GDP (Leandro and Zettelmeyer 2018). To issue the same debt via a (non-senior) intermediary, euro members would need to contribute capital amounting to around 24-29 percent of the debt stock, i.e. about 6-7 percent of euro area GDP (0.24×0.25). The capitalization costs required to issue debt via a leveraged sovereign wealth fund would be smaller, as the fund may merely require some “seed money” and could grow based on retained earnings until the desired size has been reached.

Finally, the (uncapitalized) “E-bonds” and “ESBies” proposals would not require any public money. However, they would differ greatly in other respects: E-bonds would result in some, albeit modest, redistribution benefiting lower rated borrowers while at the same time raising the cost at which these borrowers can issue additional bonds to the market, hence exerting a disciplining effect. In contrast, ESBies would have no redistributive implications and are unlikely to have a major impact on sovereign borrowing costs. For these reasons, one would think that ESBies would be the least controversial of the ideas described. However, the proposal has been criticized for its reliance on tranching (see S&P 2017, Academic Advisory Council to the German Federal Ministry of Finance 2017, and de Grauwe and Ji 2018).

Establishing a feasible regime for managing deep debt crises in the Euro area

A feasible regime for managing deep sovereign debt crises in the Euro area needs to rest on three pillars:

First, reforms to the euro area financial architecture that would the financial and economic costs of a debt restructuring in the euro area for both the restructuring sovereign and other member states, as described in the last section. The most important steps to achieve this are a change in bank regulation that would lead to the gradual elimination of concentrated exposures of banks to sovereigns – ideally in combination with the introduction of a euro area safe asset that would replace most sovereign bonds held on bank balance sheets – and the introduction of a European deposit insurance.

Second, establishing a legal framework to deal with the holdout problem. This could be achieved by amendments of the ESM treaty that would (1) require members to adopt enhanced, one-limb collective action clauses in all future sovereign bond issues, and (2) change the ESM treaty in a way that makes claims of holdouts effectively unenforceable within the Euro area (Buchheit, Gulati and Tirado, 2013). In addition, any funds borrowed from the ESM (and the ESM) should be immunized from legal action by holdouts.

Third, adopting an ESM lending policy, backed by an appropriate change to the ESM treaty, that reduces the chance of bailing out the private creditors of countries whose debts are unsustainable. This could follow the example of the IMF's "exceptional access policy" – that is, require a "reprofiling" (maturity extension, at unchanged interest rates) of privately held debts for the duration of an ESM-financed adjustment program.

The three pillars should be agreed and enacted as one package. To avoid adverse market reactions, this should take place at a time when the debts of all euro area countries that depend on market access – particularly those of high-debt countries – are widely expected to be sustainable. Furthermore, the first pillar should become effective prior to the other two. To avoid sudden changes in sovereign yields, sovereign concentration charges could be phased in slowly, combined with the gradual issuance of a safe asset backed by a portfolio of euro area sovereign bonds. As euro area sovereign bonds held in euro area banks mature, banks will have an incentive to replace these by euro area safe assets rather than freshly issued national bond holdings. Annual issuance of safe assets could subsequently be calibrated to the volume of maturing sovereign bonds in Euro area bank balance sheets, so that the demand for bonds that would ordinarily arise from the roll-over of bonds held by euro area banks would be matched or exceeded by demand arising from the creation of safe assets (see Leandro and Zettelmeyer, 2018, for details). Contributions to a European deposit insurance fund should begin in parallel.

With the construction of the first pillar underway, financial instability arising from the other two pillars is unlikely – including because the third pillar, a change in lending policies that makes it less likely that the ESM will bail out countries with unsustainable debts, would involve neither automatic debt restructuring in countries receiving ESM financial assistance nor hard debt thresholds beyond which restructuring becomes a condition for ESM lending. Furthermore, the new lending policies could be phased in gradually. For example, the ESM treaty change could stipulated that they will come into effect only after *newly issued* debt has reached a minimum volume (e.g. 60 percent of GDP, see Andritzky et al. 2016).

Conclusion

This paper set out to explain what motivated the present Euro area regime for managing deep debt crises, why it is unsatisfactory, and how it might be reformed. Its main findings can be summarised as follows.

The present euro area regime for managing debt crises was created as a compromise between conditionality-based crisis lending by the ESM and burden sharing with private creditors, based on collective action clauses incorporated in euro area bond contracts since 2013. The latter are meant to be used if and only sovereign debt cannot be made sustainable through a combination of official financing and policy adjustment. To ensure that this happens, the ESM treaty envisages co-lending with the IMF, which is assumed to know when debt is sustainable, and is bound by its own rules to lend only when this is the case.

The philosophy behind this compromise is right. In practice, however, the private sector burden sharing leg of the current Euro area compromise does not work. This is partly for technical reasons (the “Euro-CACs” embodied in euro area bond contracts are an inadequate tool for dealing with the so-called holdout problem). The more fundamental reason, however, is that calling for co-lending with the IMF is no match, as a commitment device to prevent inappropriate bailouts, for the economic and political costs of debt restructurings. These will make bailouts look attractive even in a deep debt crisis – in spite of the risk that these bailouts may not be repaid, or may be repaid only at prohibitive cost to the domestic taxpayer. Recognising this fact, several recent policy proposals have called for both better devices to deal with holdouts and tougher commitment devices – for example, imposing hard limits on how often the ESM can lend, in what amounts it can lend, or in what circumstances it can lend.

This paper has argued that while the aim of these proposals is sensible – safeguarding taxpayer money and improving incentives – it would be wrong to rely mainly on hard commitment devices to achieve this aim, for three reasons. First, introducing such devices at a time when debts are already high can give rise to a crisis, while committing to delayed introduction may itself not be credible. Second, hard commitment devices need to be simple to be hard. They could therefore give rise to large errors: forcing countries into a restructuring when this is not needed. Third, and most importantly, even supposedly hard devices may not be credible when the economic costs of debt restructurings are very high.

The key to improving the management of deep debt crisis in the Euro area is hence to tackle the problem that creates a need for commitment devices in the first place: the large economic costs of debt restructurings. This requires (1) eliminating concentrated sovereign exposures of banks, particularly to their own sovereigns and (2) creating a European deposit insurance system that credibly protects deposits even if the national sovereign is insolvent. Fears of

contagion could be reduced by introducing a euro area safe asset that would gradually replace sovereign bonds in bank balance sheets, providing straightforward access to ESM liquidity to prequalified countries and creating a “rainy day fund” that would provide budgetary support in the event of large economic shocks. In addition, the legal framework for dealing with holdouts should be improved by requiring euro area governments to adopt enhanced, “one limb” collective action clauses in their bond contracts and by protecting the ESM and funds provided by the ESM from legal action by holdouts.

With these measures in place, ESM policies to prevent bailouts of countries with unsustainable debts will still need to be strengthened, but without requiring hard devices such as automatic debt restructuring in the event of an ESM programme, or debt-to-GDP thresholds to decide whether a country may receive ESM assistance without a restructuring. Adopting a lending policy analogous to the IMF’s “exceptional access policies”, which preserves some discretion in deciding when debts are unsustainable but requires a maturity extension when sustainability is uncertain, would be sufficient.

To summarise, moving towards a better regime for managing deep debt crisis in the Euro area – and providing better incentives to avoid them – requires a reduction in the economic costs of debt restructuring, legal tools for dealing with holdouts, and ESM lending policies that prevent the bailout of countries with likely unsustainable debts. The first of these steps is important not just in itself, but because ESM policies would no longer need to be designed to achieve the hardest possible commitment effect. With less pressure to circumvent the intention of the policy, there would be more room for discretion and pragmatism. This should in turn reduce the chances that these policies have unintended costs – and hence increase the chances that they will in fact be followed.

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