

Comments on:
William R. Cline
Euro Area Debt Crisis

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The 5(+) Pillars of the EDSM

1. Growth rate of real GDP: g
2. Effective real interest rate on public debt: r
3. Extraordinary outlays % of GDP: c
4. Primary surplus as % of GDP: s
5. Proceeds from privatisation as % of GDP: p
- 5+1. Initial debt-to-GDP ratio: d
- 5+2. Rate of inflation of GDP deflator: π
- 5+3. Effective nominal interest rate on public debt: i
- 5+4. Growth rate of nominal GDP: n

Debt dynamics

$$\Delta d_t \equiv \left(\frac{r_t - g_t}{1 + g_t} \right) d_{t-1} - s_t + c_t - p_t$$

or

$$\Delta d_t \equiv \left(\frac{i_t - n_t}{1 + n_t} \right) d_{t-1} - s_t + c_t - p_t \tag{1}$$

Correlated contingent states s, c, p, r, g

Necessary condition for solvency

- Variables with overbars denote *permanent* magnitudes

$$\bar{s} \geq \left(\frac{\bar{r} - \bar{g}}{1 + \bar{g}} \right) d_{t-1} + \bar{c} - \bar{p}$$

or

$$\bar{s} \geq \left(\frac{\bar{i} - \bar{n}}{1 + \bar{n}} \right) d_{t-1} + \bar{c} - \bar{p}$$

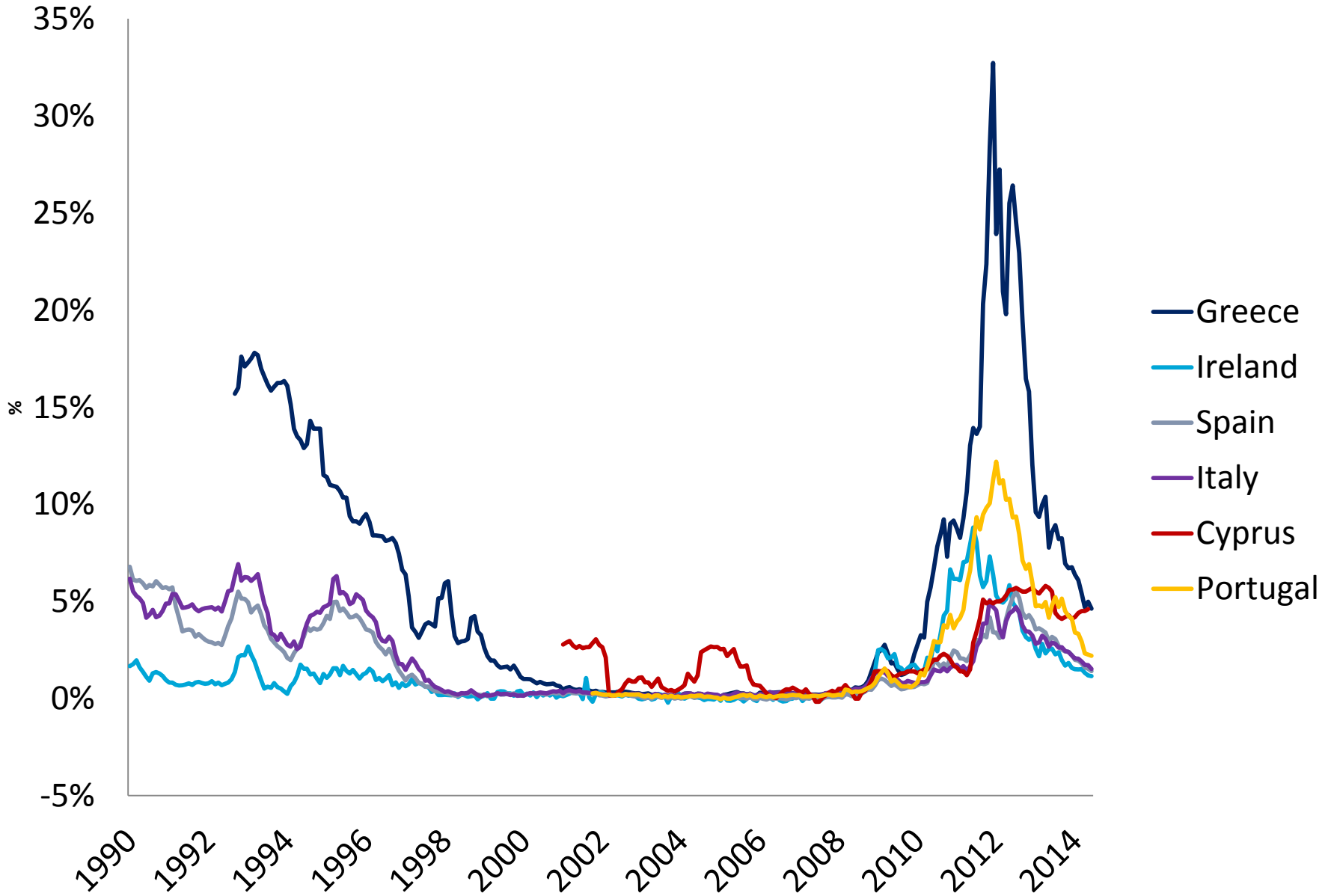
(2)

With what probability is $\bar{s} \leq$ or $> s^{\max}$ (3)

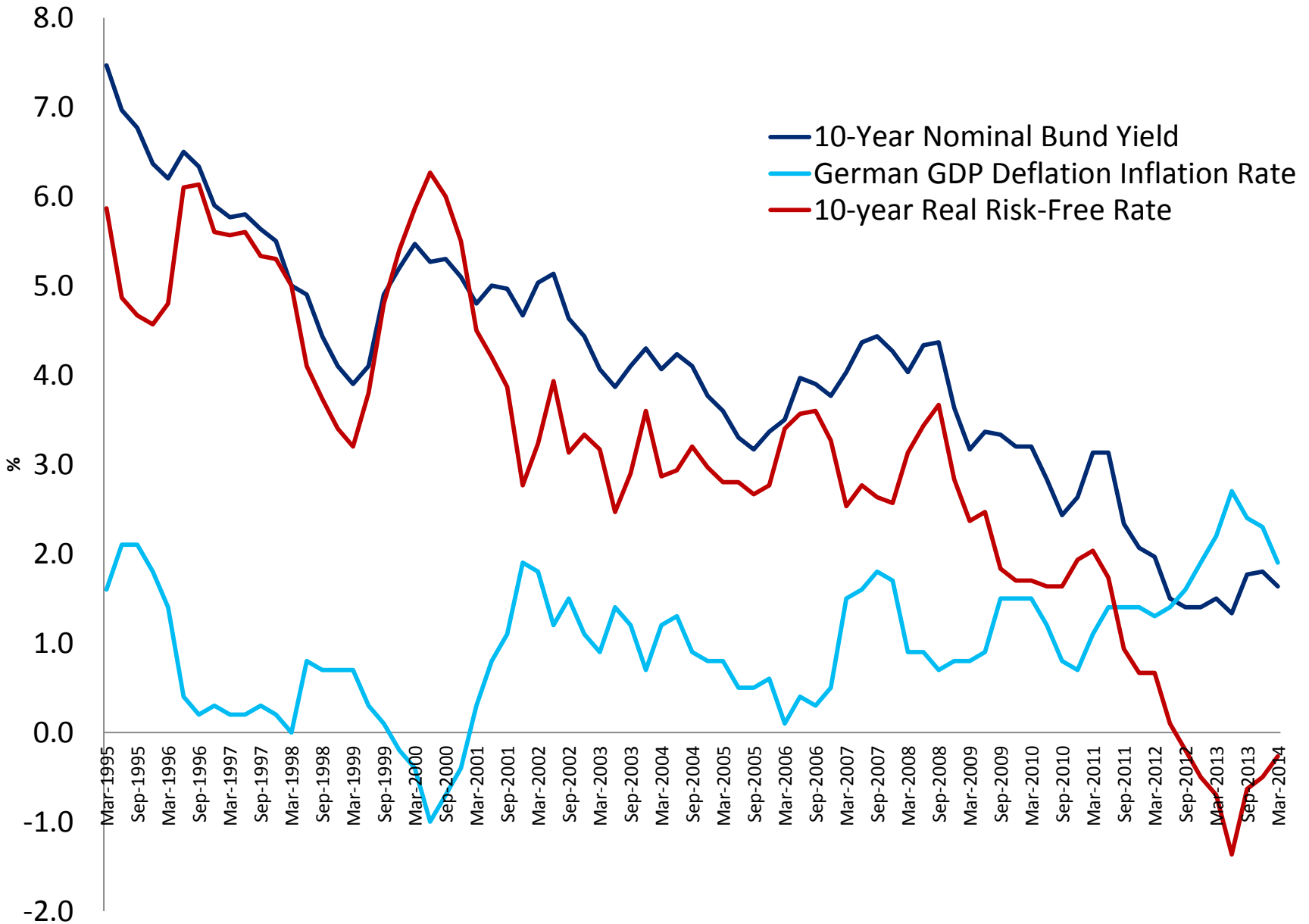
Eyeball Calculations

- Periphery sovereigns will not spend much more rescuing their banks and other SIFIs.
- Privatisation is likely to cost the sovereign
 - Treuhandanstalt 1990-1994
 - 8,500 state-owned enterprises
 - Massive agricultural land & forests
 - Huge amount of property
 - Ended up with cumulative loss of 260bn-270bn
- Neutral risk-free real rate likely to rise in EA
- Sovereign risk-spreads in EA Periphery likely to rise, despite presence of OMT

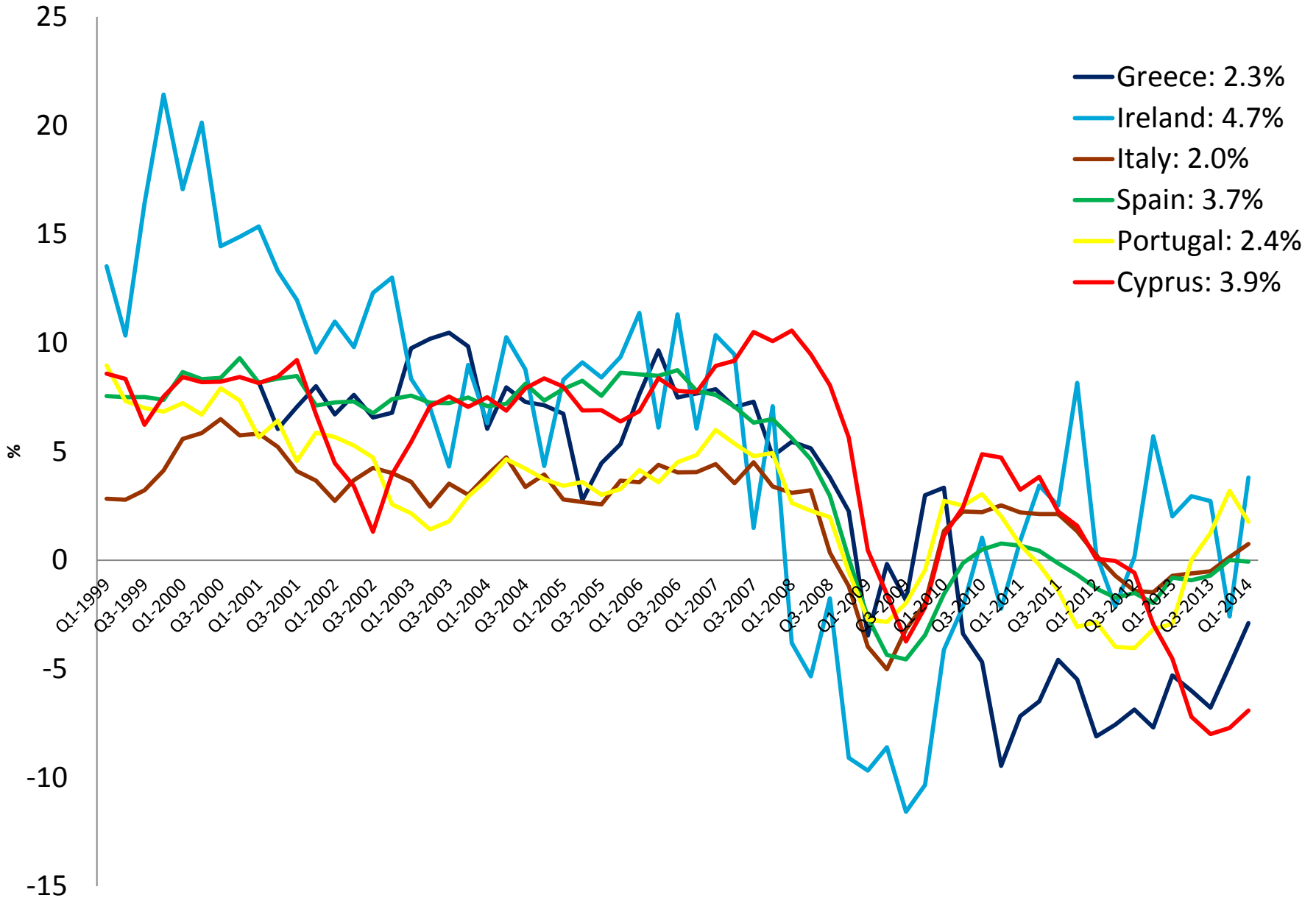
Periphery 10-year Sovereign Spreads v. Bunds



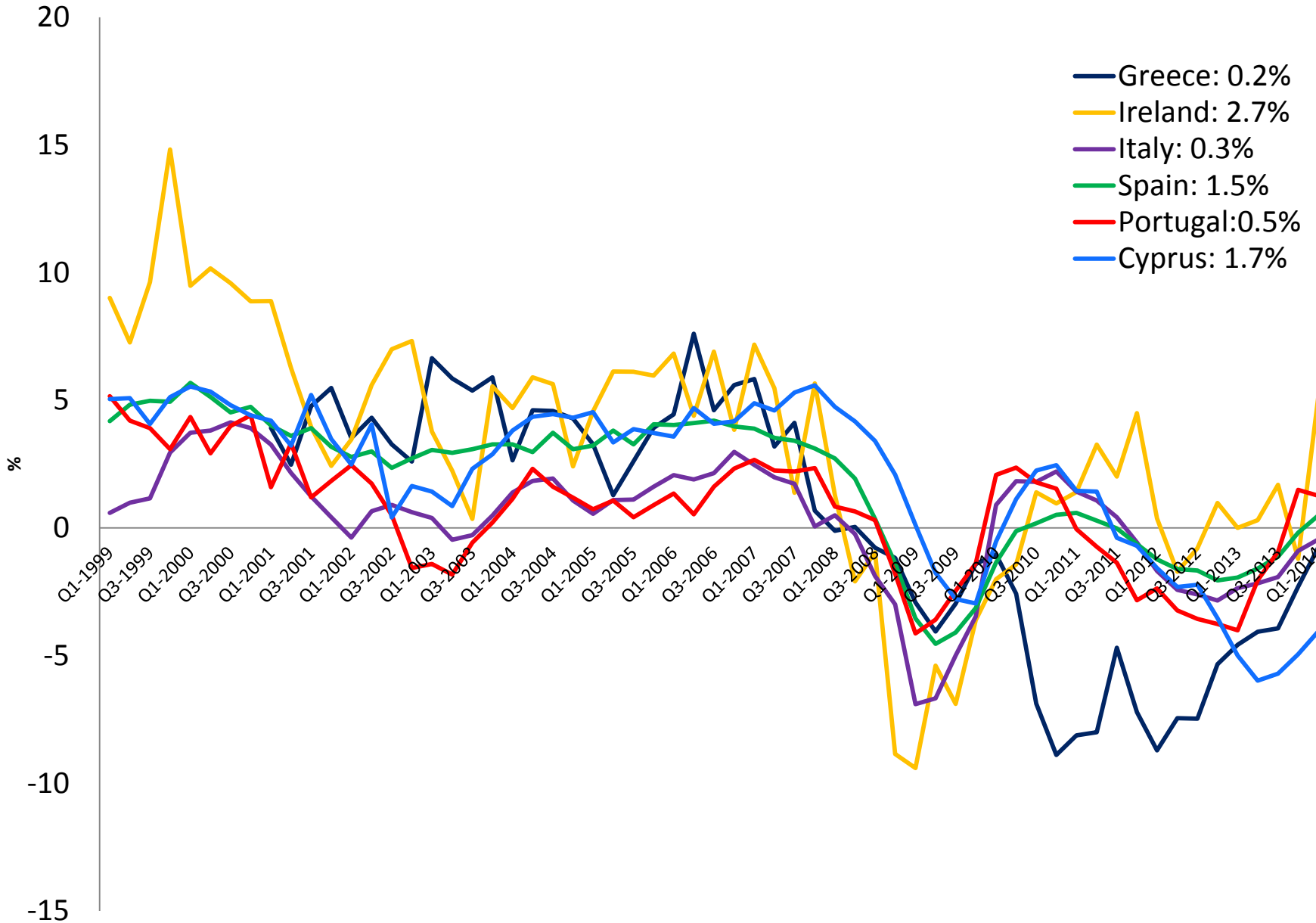
10-year Bund Yields - Nominal and 'Real'



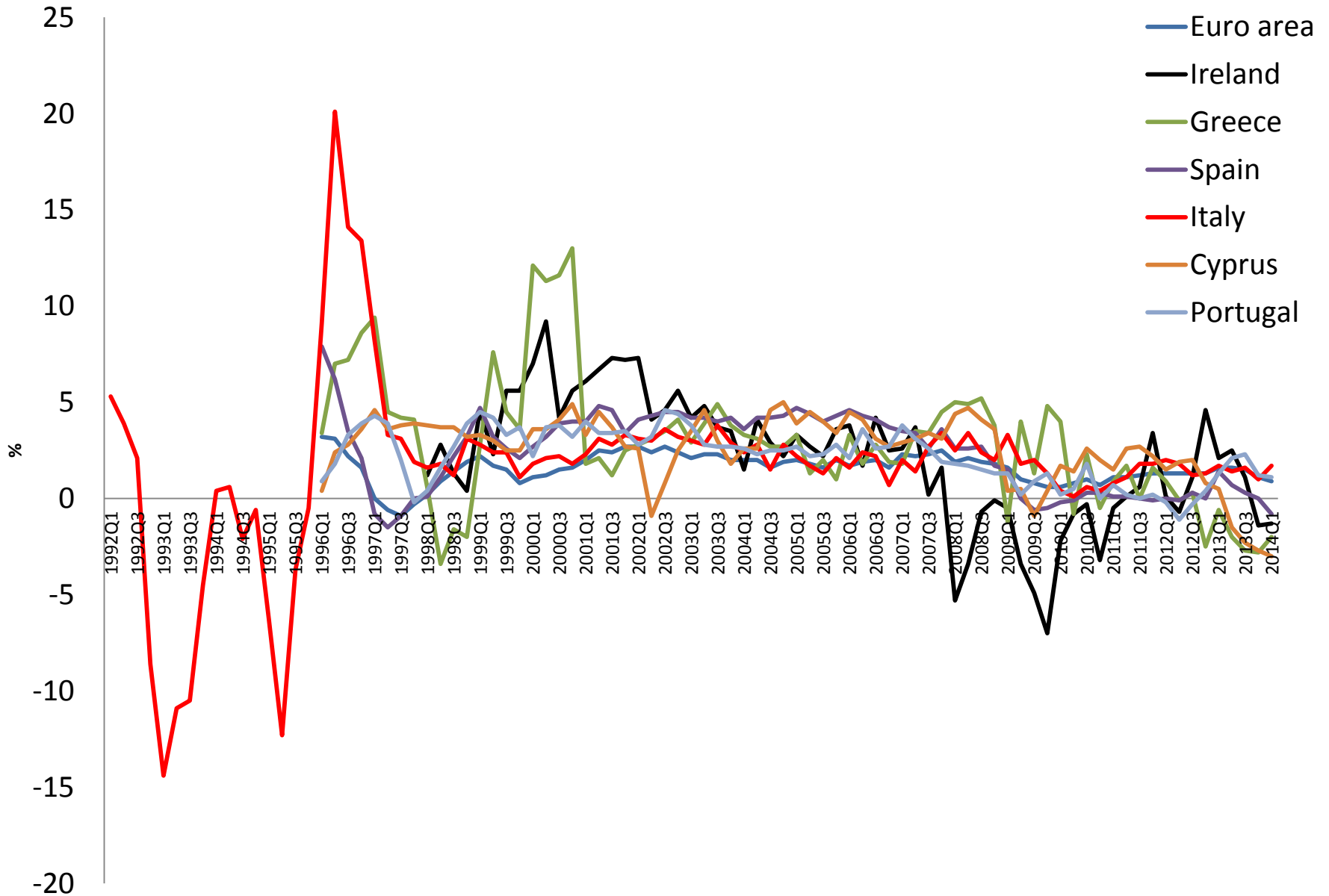
Nominal GDP Growth Rates (YoY) in the EA Periphery



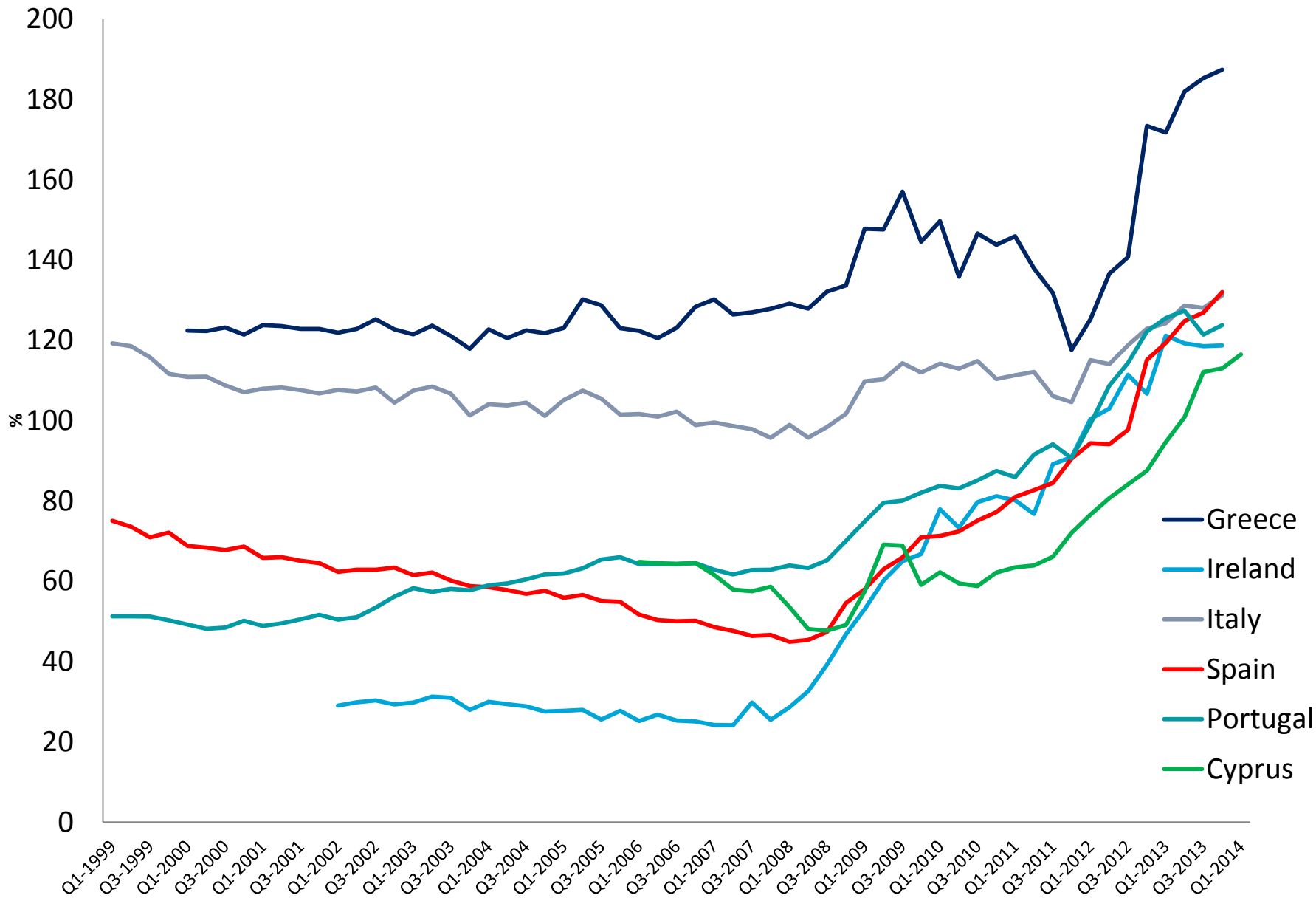
Real GDP Growth Rates (YoY) in the EA Periphery



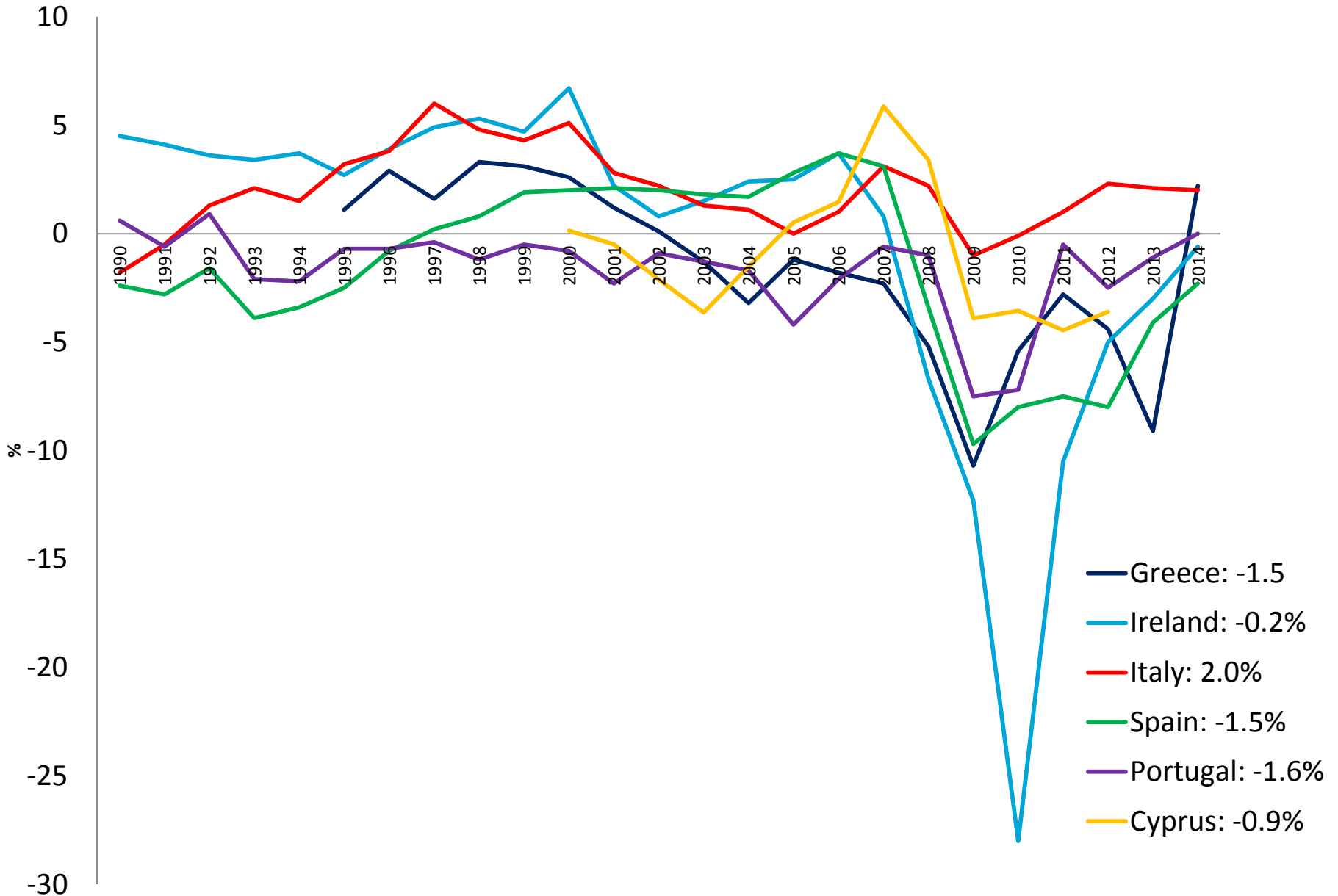
GDP Deflator Inflation Rates (YoY) in EA and EA Periphery



General Government Gross Debt as a % of GDP in the EA Periphery



Primary Budget Balances as a % of GDP in the EA Periphery



Points of Agreement

- Every sovereign needs a lender of last resort – its central bank. In the EA, the sovereign LoLR is the ECB through the OMT.
- Euro Area break-up would involve large economic costs (& even larger political costs)
- 120% of annual GDP as a threshold for sovereign debt sustainability is arbitrary - see first 3 post-WWII decades

But:

- Legitimacy of public debt
- Higher real growth rate
- Greater inflation tolerance
- Financial repression
- Private sector not over-leveraged (esp. banking sector and household sectors)

Points of Disagreement

- All EA periphery sovereigns (Greece, Cyprus, Italy, Portugal, Spain and Ireland) are at material risk of sovereign default.
- Ireland's sovereign is solvent only if the ECB meets its inflation target (is mandate-consistent).
- Spain's sovereign requires for solvency:
 - Mandate-consistent ECB
 - No Catalexit
 - No fiscal S&M
 - Significant further structural reform
- Portugal's sovereign requires for solvency:
 - Mandate-consistent ECB
 - No fiscal S&M
 - Very significant further structural reform
 - A well-behaved Constitutional Court

Points of Disagreement ctnd

- Italy's sovereign requires for solvency:
 - Mandate-consistent ECB
 - No fiscal S&M
 - Heroic structural reform, which requires:
 - Electoral reform
 - An election that produces a durable, reform-minded majority
 - Legislation and implementation of far-reaching reforms
- Cyprus's sovereign requires for solvency:
 - No further bank recapitalisation outlays
 - Successful transformation into a post-tax haven/ml economy
- Greece's sovereign requires for solvency:
 - A miracle

Conclusions

- Sovereign debt restructuring is likely in a number of EA Periphery member states
- Sovereign debt restructuring may be desirable even if it is not unavoidable
- The EA should have an SDRM as part of an EMF that includes the ESM as a source of conditional liquidity
- The holes in the balance sheets of EA banks are likely to be large but are unlikely to threaten sovereign solvency
- The EA cannot survive without banking union
 - Goals:
 - Decoupling sovereign and national banking sector credit risk
 - Restoring monetary transmission mechanism
 - Key elements:
 - A single rule book
 - A single supervisor
 - A single bank recovery and resolution mechanism capable of bailing in SUCs
 - A common fiscal backstop
 - A LoLR
 - A common deposit guarantee scheme would be nice but not essential

Appendix A-1

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