

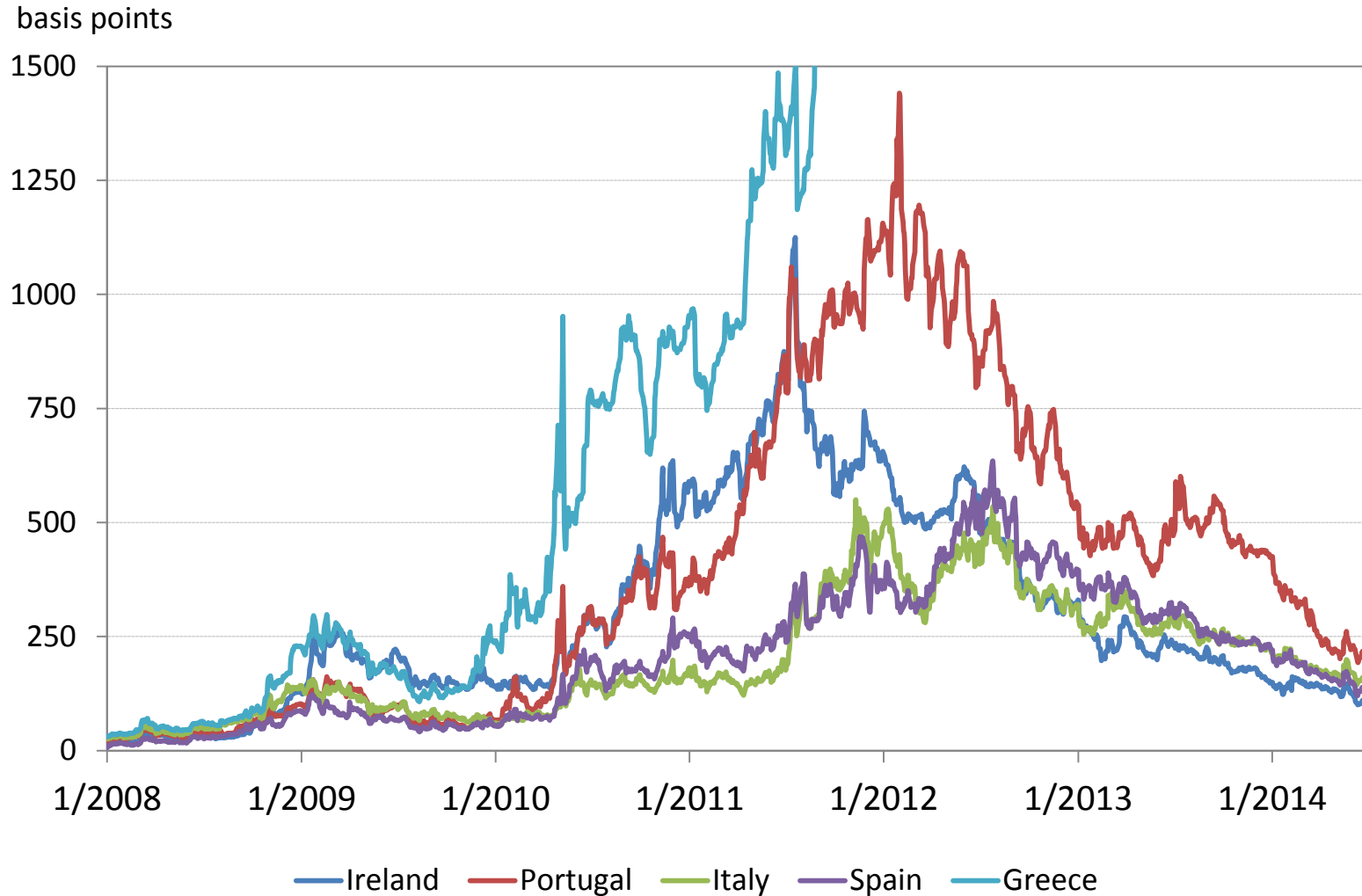
Managing the Euro Area Debt Crisis

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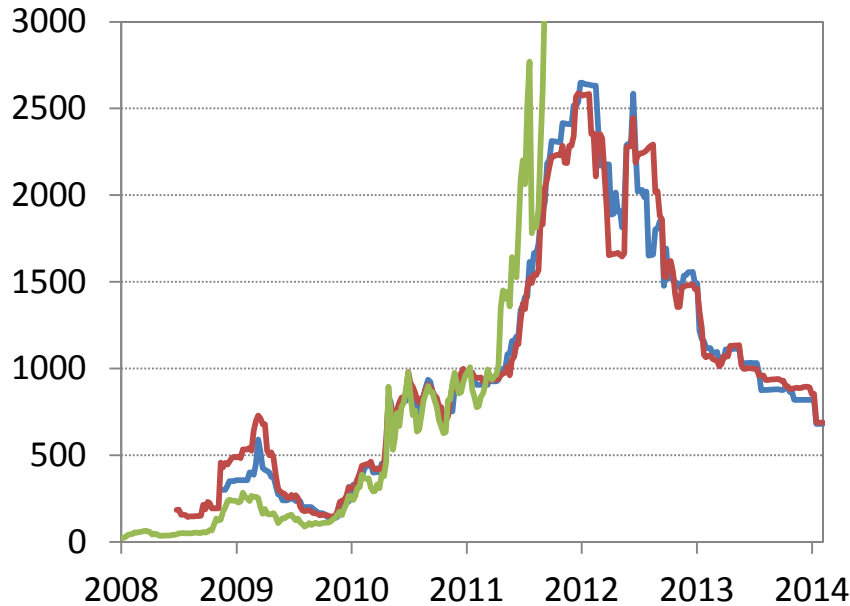
Sovereign Risk Spreads, 10-year



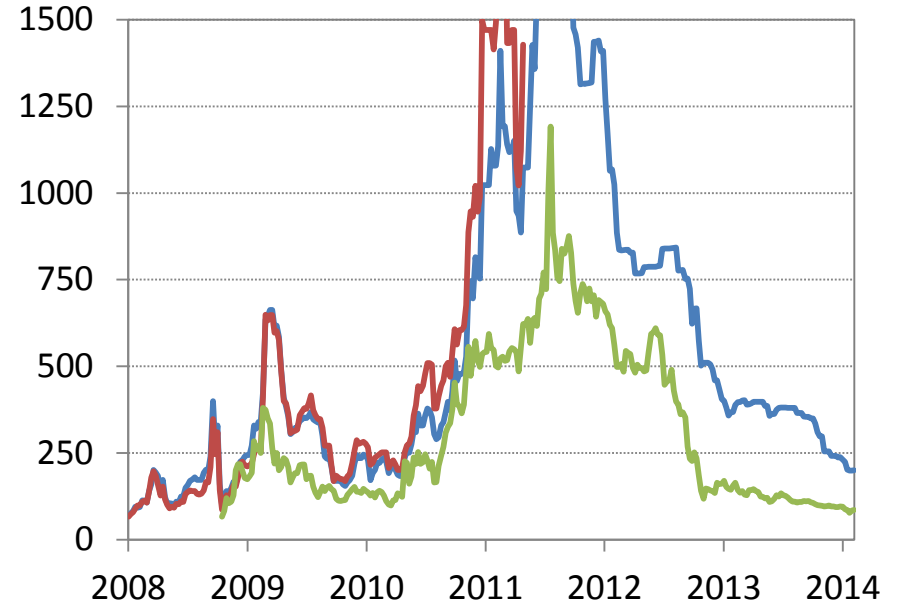
Key Issues

- Fiscal adjustment versus growth?
- Bank-sovereign doom loop
- Role of external adjustment

Credit default swap rates (bp): sovereigns and banks in Greece and Ireland



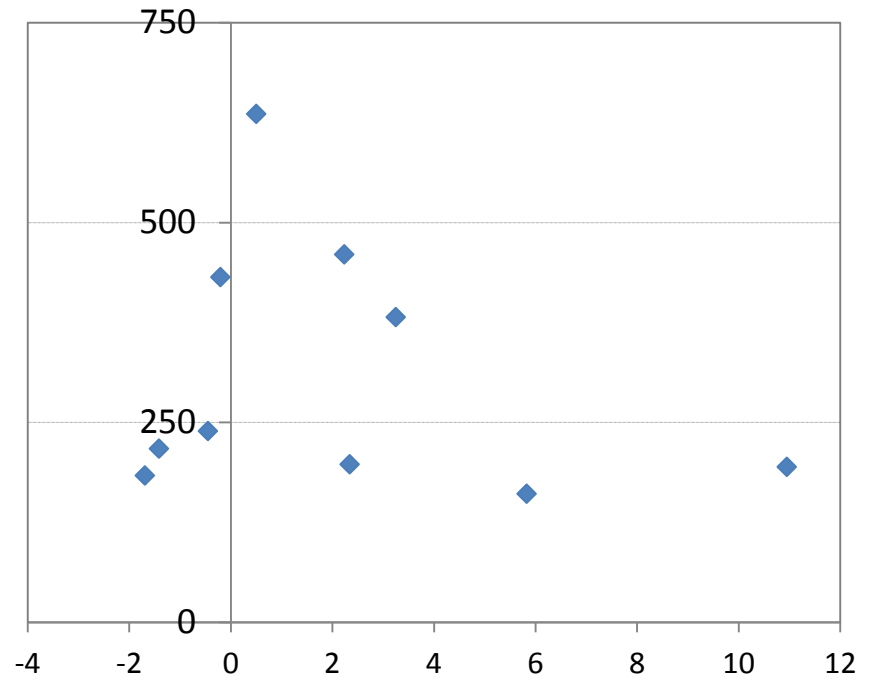
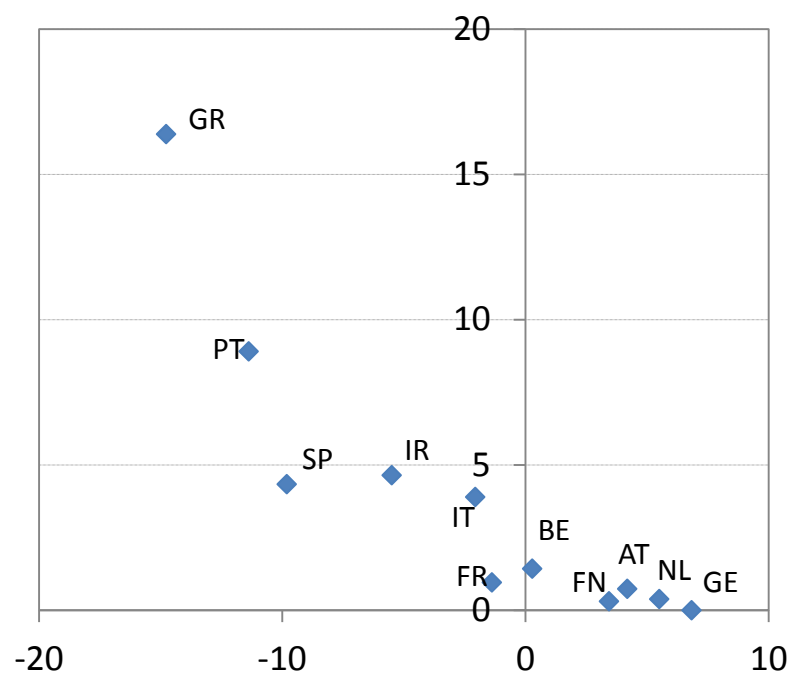
Greece



Ireland



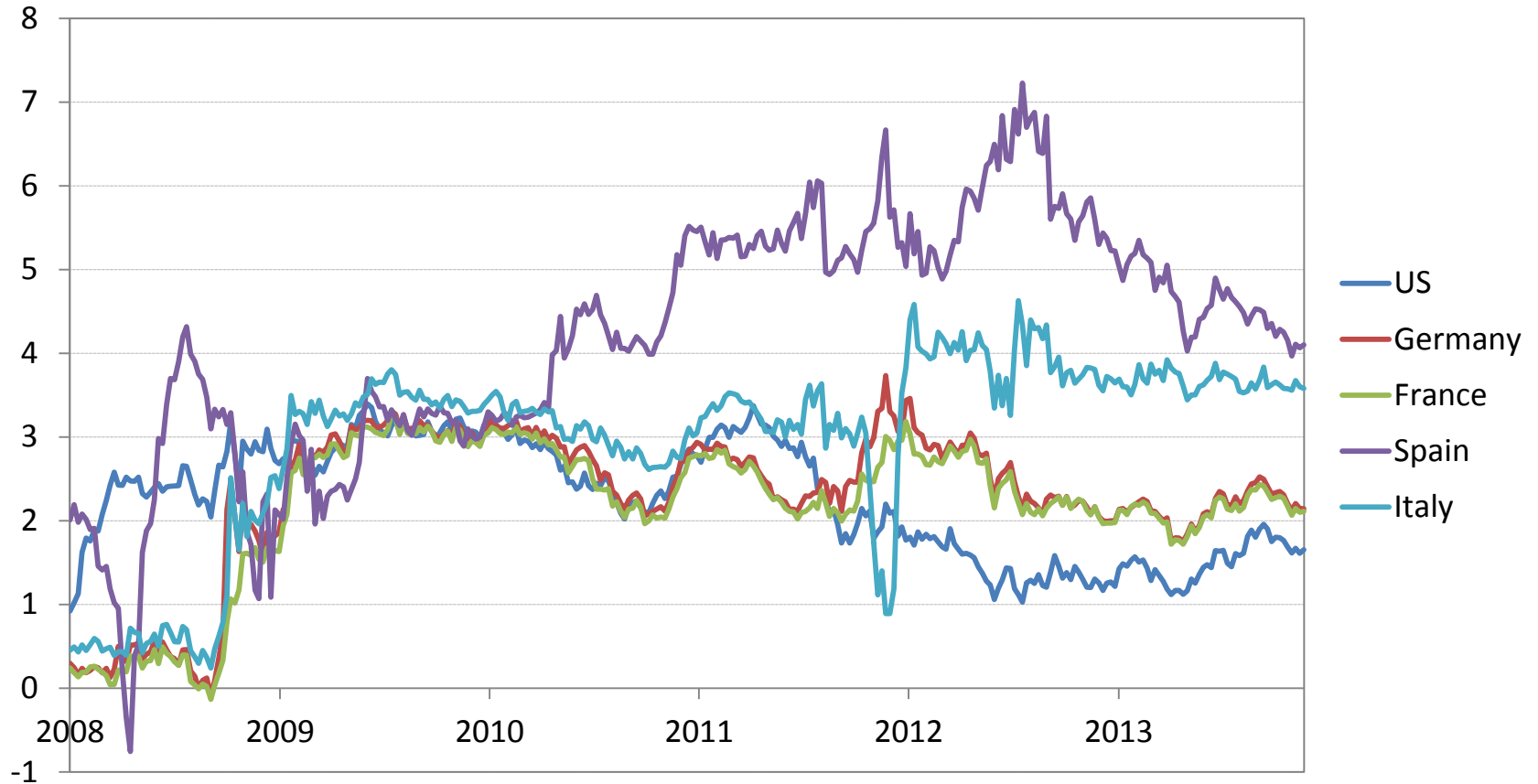
Spreads in 2012 (%) against 07-08 current account (% GDP; left) and in 2013 (bp) against 2012-16 current account (%GDP; right)



Key Issues (2)

- OMT as key firewall
- Greece as special case
- Institutionalize debt restructuring mechanism??
- Quantitative easing?

10-year vs 6-mo term premium



Debt Sustainability Condition

- Primary (non-interest) surplus %GDP =
[Debt/GDP ratio] x [Interest rate – growth rate]

$$s = [D/Y] \times [r - g]$$

Example: Italy 2014-20:

$$s = 4.5\%; D/Y = 1.24; r = 4.2\%;$$

$$g = 2.6\% (1.2\% \text{ real} + 1.4\% \text{ inflation})$$

$$4.5\% > (1.24) \times (4.2\% - 2.6\%) = 2\%$$

Scenarios for Italy

	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth (percent)								
1	...	0.2	0.6	0.9	0.9	0.7	0.7	0.7
2	-1.8	0.7	1.1	1.4	1.4	1.2	1.2	1.2
3	...	1.0	1.73	1.73	1.73	1.73	1.73	1.73
Primary surplus (percent of GDP)								
1	...	2.3	2.7	2.7	2.7	2.7	2.7	2.7
2	2.0	3.3	3.6	4.5	5.1	5.6	4.6	4.6
3	...	3.8	4.3	5.1	5.7	5.7	5.7	5.7
Aid to euro area; discovered debt (billion euros)								
1	...	22	0	1	1	0	0	0
2	20	22	0	1	1	0	0	0
3	...	22	0	1	1	0	0	0
Privatization (billion euros)								
1	...	0	0	0	0	0	0	0
2	0	11	16	17	17	0	0	0
3	...	15	20	21	21	0	0	0

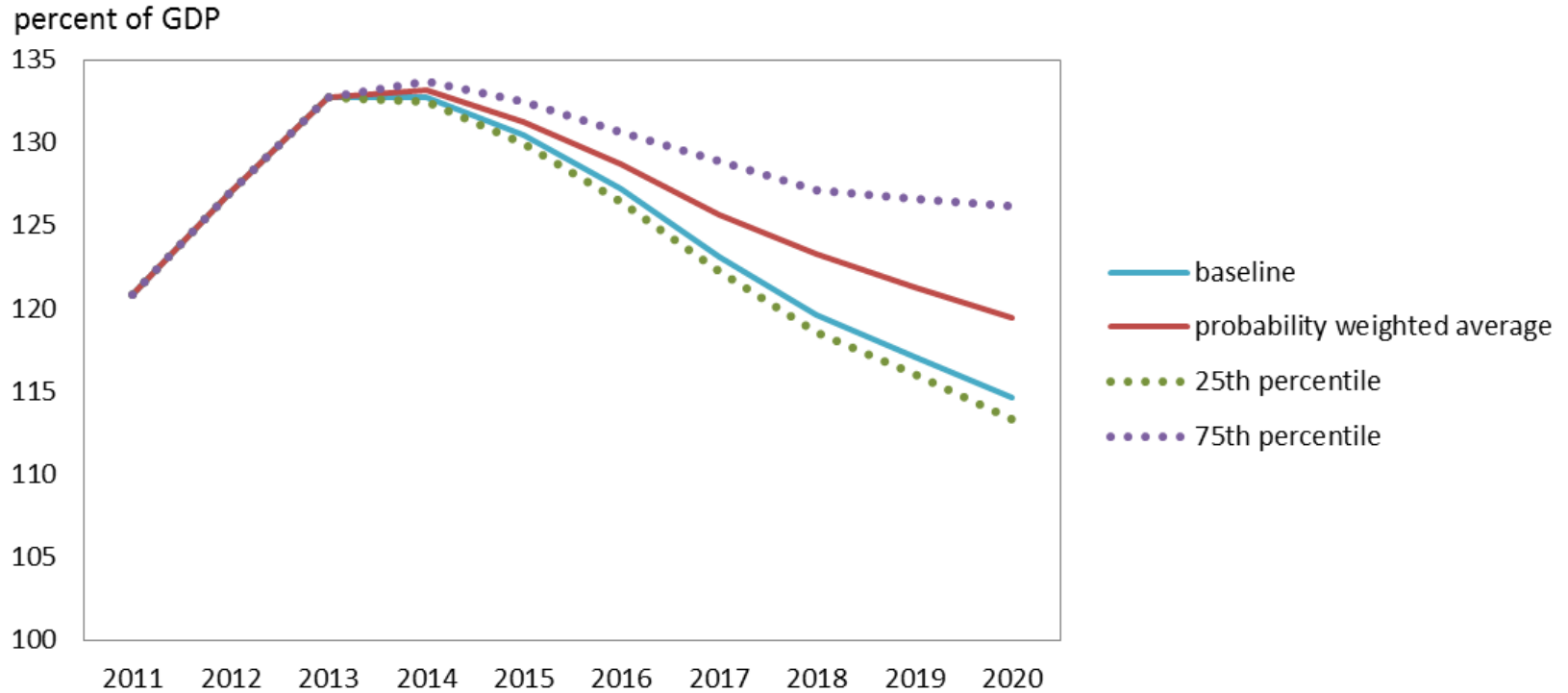
Scenario: 1= unfavorable; 2 = baseline; 3 = favorable

State Correlation Coefficients

(good w/good = 1; good w/bad = -1)

	Growth (g)	Primary surplus (π)	Interest rate (r)	Bank recapitalization and debt discovery (DDIS)	Privatization (Z)
g		0.2	1	0.5	0
π	0.2		-0.5	0	-1
r	1	-0.5		1	0
DDIS	0.5	0	1		0
Z	0	-1	0	0	

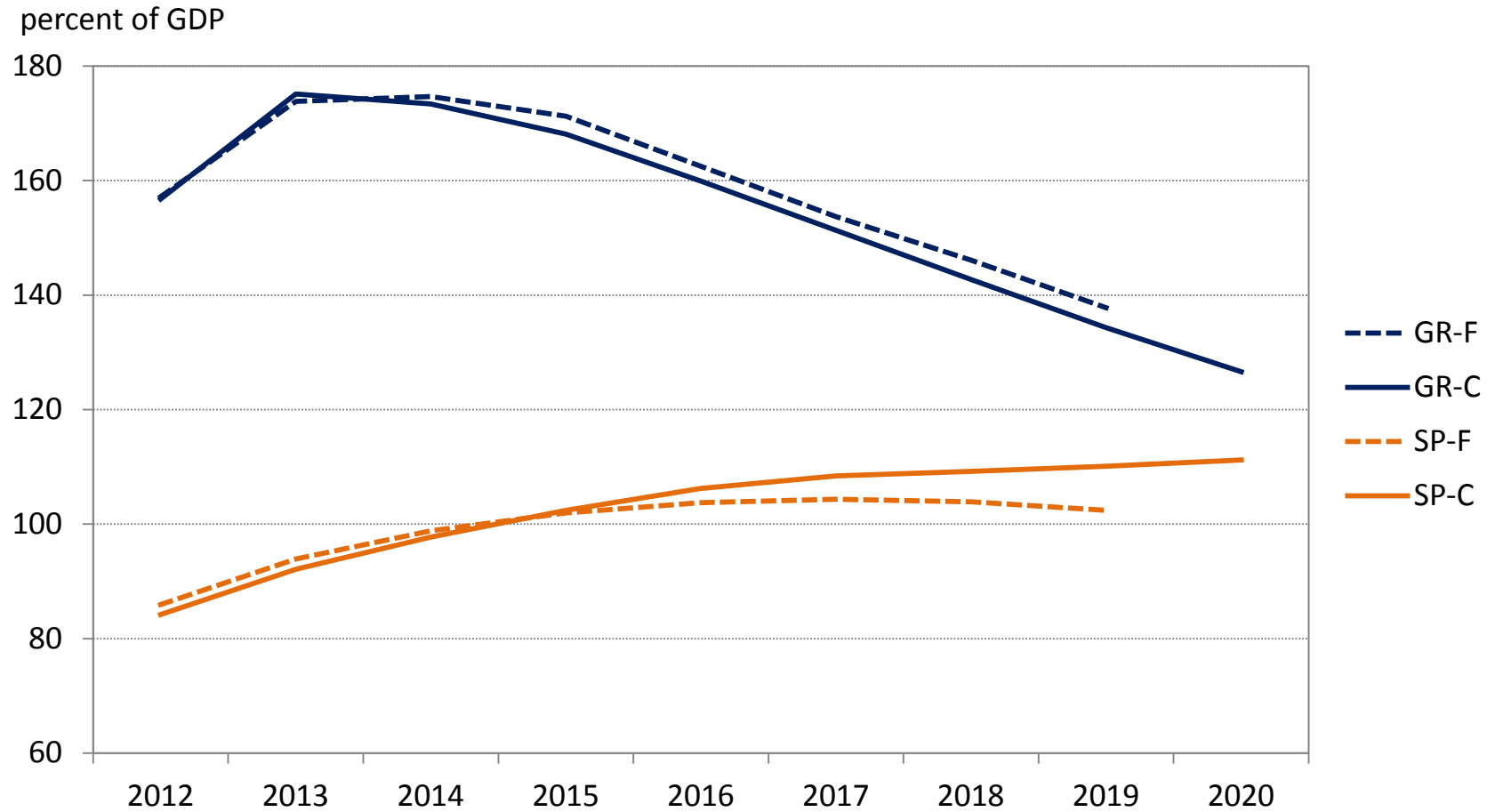
Italy: Gross Debt as % of GDP



Average Economic Performance, 2014-20 and Debt as % GDP

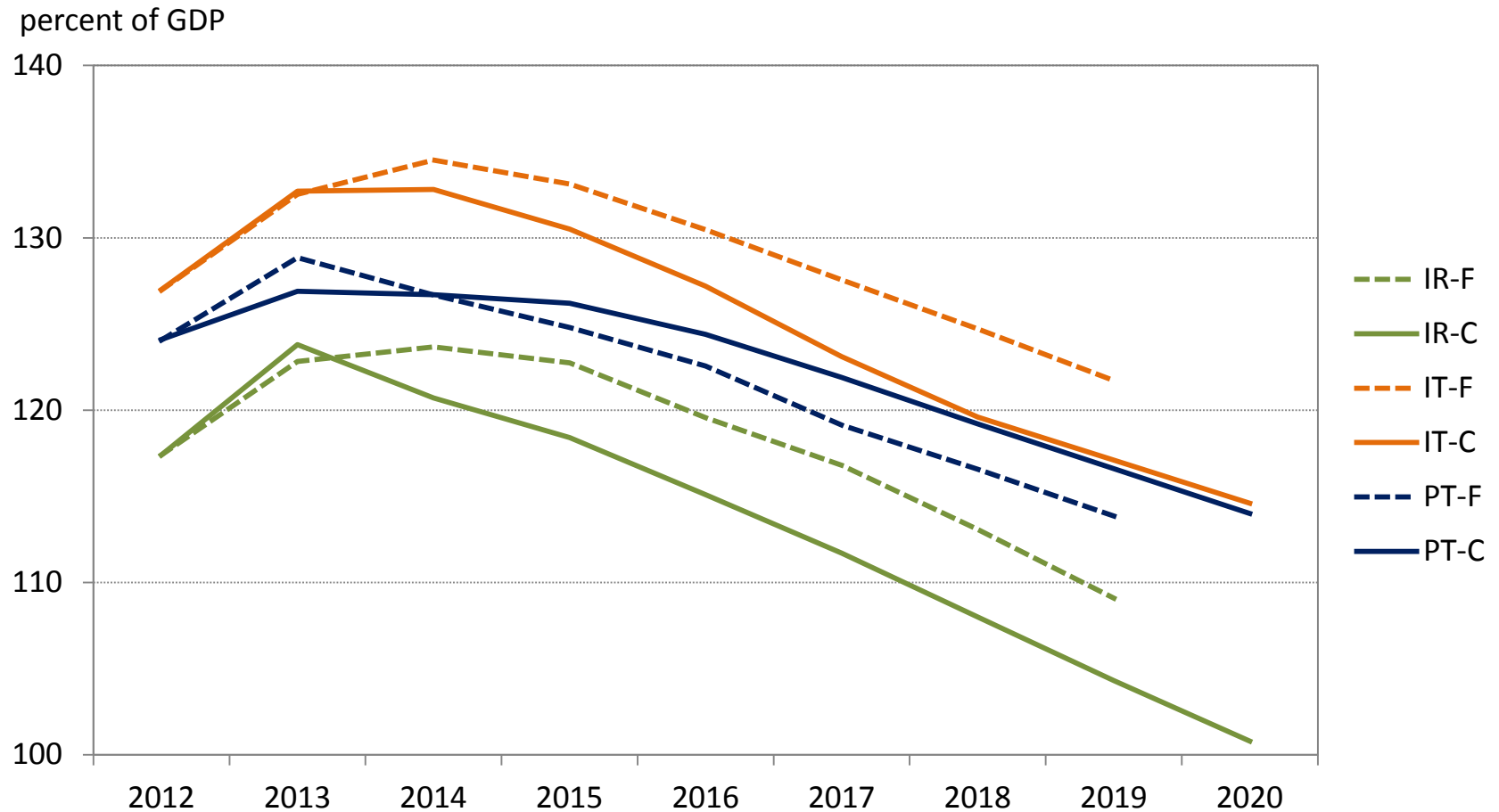
	2014-20 Average Economic Performance			Debt (percent of GDP)		
	Growth (%)	Primary surplus (% GDP)	Sovereign Risk Spread (bp)	2013 Actual	2020 Baseline	2020 Prob.-wtd.
Ireland	2.4	2.7	150	124	101	98
Italy	1.2	4.5	189	133	115	119
Portugal	1.6	2.4	239	127	114	114
Spain	0.8	0.2	189	92	111	107

Debt Baselines Compared to 2014 WEO: Greece, Spain



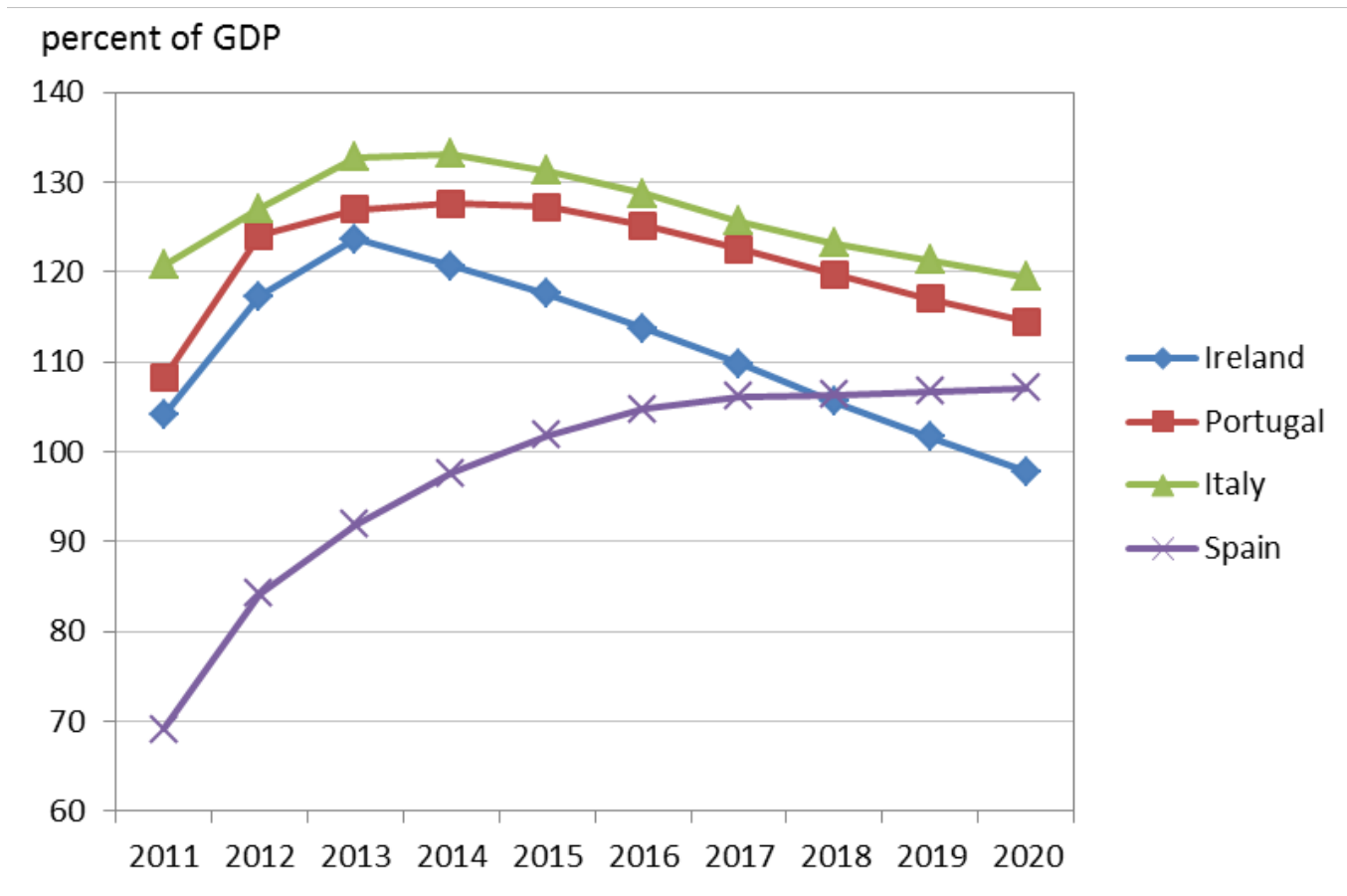
Note: F = Fund estimate; C = Cline estimate

Debt Baselines Compared to 2014 WEO: Ireland, Italy, Portugal



Note: F = Fund estimate; C = Cline estimate

Probability-weighted debt /GDP paths



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