THE NEED OF DEBT RESTRUCTURING IN THE EUROZONE – OPTIONS AND REALITY

Stanislav Šaroch

Abstract

The debt problem in the Eurozone cannot be avoided or hoped away. The article examines different opportunities of dealing with the debt burden. There are many options how to address the debt problem. Due to dramatic circumstances a number of modifications to the original rules of the SGP such as the Six-Pack, Two-Pack and Fiscal compact became politically acceptable. However, budget stabilization cannot work for a long time in the southern EU countries being permanently in recession. There are several ways how to lower the debt burden - higher inflation, various types of state bankruptcies, federalization of Europe and takeover of the debt by a common fiscal authority or an institutional solution that requires only minimal adaptation of the existing institutional structure of the EU. The latter one being a permanent "burial" of the excessive part of current debt on the balance sheet of the ECB. Under certain conditions it is possible to design this solution as non-inflationary and by exclusion of the risk of future moral hazard in public debt incensement.

Key words: public debt, austerity, economic growth, debt restructuring

JEL Code: E62, H50, H63

Introduction

The debt crisis in the Eurozone reached a stage where some politicians talk optimistically about managing the situation by a number of institutional arrangements. The effectiveness of these measures though - whether it is the fiscal compact and the establishment of a banking union - is very controversial, just because of the particular setting of those measures. High levels of national debt would - without other measures to be simultaneously taken - greatly complicate and limit future economic growth. The aim of the following article is to explore ways how to reduce the national debt to a level that would not limit the future growth of the EU economy.

1 Public debt, deficits and contemporary institutional framework for debt sustainability in the EU

The fiscal rules for the EU - both fiscal criteria of the Maastricht Treaty and later the Stability and Growth Pact - have always contained a number of restrictions under which they perform their original purpose which is to preserve sound public finances in EMU. The first limitation is related to the assumptions and theories on which the value of the "right amount" limit of deficits and public debt (3%, or 60% respectively) were set arbitrarily. They were derived in the 1990th on the basis of so-called budgetary arithmetics (or debt arithmetics) for growth parameters of the EU back than and extrapolated on to the future. EU at this time consisted of 12 member states and the growing trend in the nominal rate reached 5 % per year. This use of the "debt arithmetic" approach did led to "one-size-fits-all" parametric rule in public finance. These criteria were too tight for fast growing converging economies, while for stagnating countries, on the contrary, these criteria were very loose. One can, however, argue that the simplicity and clarity of the rules are - as the theory postulates - sufficient justification for this simplified mechanistic approach in fiscal arithmetics.

Stability and Growth Pact did not only kept those rules but also added the medium term objectives which obliged the member states to achieve nearly balanced budgets in the medium term. The term of reporting about the implementation of these objectives and planning were (and are) the convergence (for countries with a derogation in the Euro adoption) and stability (for countries using the Euro) programs that the member states periodically submit to the European Commission. Right from the start, however, the system had a large deficit in the options to enforce compliance with the rules and the enforcement of sanctions. In the wake of the introduction of the Stability and Growth Pact into practice the two key major economies - Germany and France - have failed in respecting the public budget deficit criterion. The voting system set in the Council has led to the fact that finally, in 2003, these countries were not even sanctioned by the covenant anticipated in the corrective part of the Pact. A second major limitation was therefore the enforceable compliance with these rules including the application of sanctions. At that nothing has changed, not even by a slight modification of the Pact, adopted in 2005.

The so-called debt part of the Pact – stating that overreaching the 60 % debt to GDP ratio is only possible provided that the debt to GDP ratio is approaching the reference value at a satisfactory pace – remained completely overlooked. Among the highly indebted Euro zone economies only Belgium managed to reach the needed primary surpluses in the pre-crisis period. Italy and Greece have not acted that way and Greece and Portugal did not reach even positive primary surpluses. And that is more or less benevolently taken into account by other signatories of the Pact and without any reflection of the different risk of sovereign debt by financial markets.

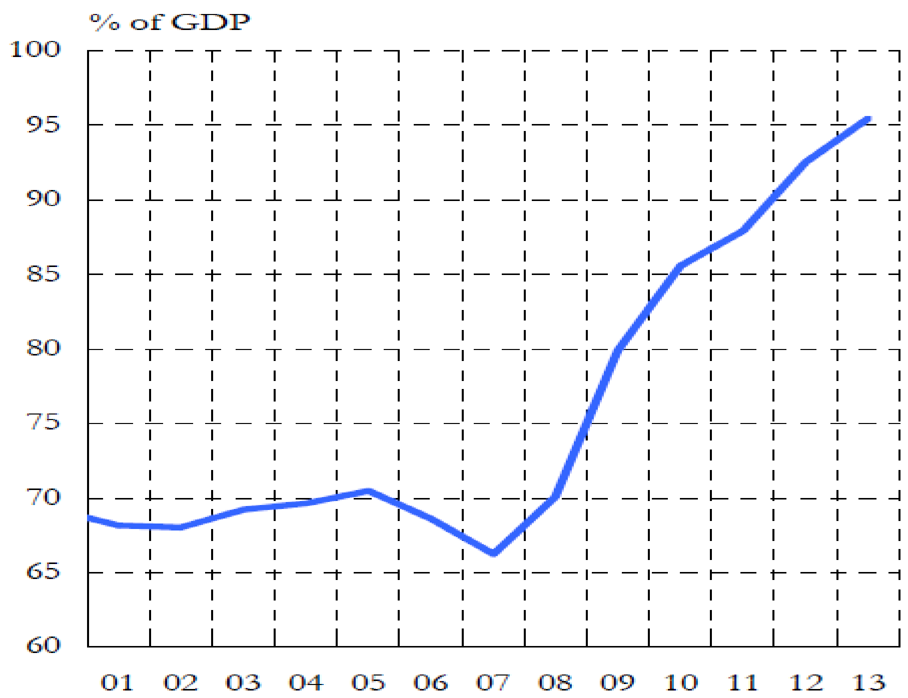
The debt crisis in the Euro zone brought a number of measures which were enforced by the circumstances - in addition to the partial restructuring of Greek debt, “politically correctly” known as PSI (Private Sector Involvement), together with official assistance of Troika (Official Sector Involvement), followed by assistance to other states such as Ireland, Spain, Portugal and by extraordinary measures by the ECB pursuing stabilization of market access in bond markets for Spain, Portugal and Italy[1].

Due to these dramatic circumstances a number of modifications to the original rules of the Pact such as the Six-Pack, Two-Pack and Fiscal compact became politically acceptable. (Dědek 2013), (Wawrosz 2013). Disciplinary elements were included into the preventive branch of the Pact. Member states which do not fulfill their mid-term objectives are newly subject to additional duty of keeping prudent growth of their budget expenditures. Violation is punishable under precisely defined quantitative terms. In the corrective arm of the Pact numerical rules to reduce excessive debt were introduced; *the reverse qualified majority voting* in the Council made a very important change too.

Institutional rules for fiscal policy thus became stricter and – thanks to the measures described above – their proper enforcement is more likely. In the meantime though, sovereign debts in the EU has grown to such a height that their repayment by these rules may make future economic growth impossible, see for example (De Grauwe, Ji 2013) or (Wyplosz 2012) among others . The following chart shows the development of the debt in the Euro zone as a whole, its decomposition is shown in table 1:

Fig. 1: General government debt in the Euro Area

[1] Solution of the insolvency of banks in Cyprus, where by the principle of bail-in was used first will be left aside as this article focuses on the issue of sovereign debt, not the restructuring of the banking sector, although these issue are potentially closely related.



Source: Key indicators for the euro area, DG ECFIN March 2014

Tab. 1: General government debt in the Euro Area Countries

Member state	Debt/GDP 2013
BE	99,8
DE	79,6
EE	10,0
IE	122,3
EL	177,3
ES	94,3
FR	93,9
IT	132,7
CY	112,0
LV	38,4
LU	24,3
MT	72,0
NL	74,3
AT	74,6
PT	129,4
SI	71,9

SK	54,3
FI	57,2
EA	**95,5**

Source: Key indicators for the euro area, DG ECFIN March 2014

An increase in economic growth is the only sustainable way to debt reduction. But such high debt levels, that we can see in the table, have operated through various channels to limit growth possibilities. Efforts to reduce public debt ratio through fiscal austerity have had virtually no success since austerity curtails nominal GDP growth (Malý 2013).

2 Alternative ways of reducing the debt to a level not limiting economic growth

As we can see in the chart for the Euro area and in the table that provides information on the level of debt in the Member States, the total debt in the Euro area greatly exceeds the rate of 60 % and is approaching the 100 percentage of GDP. The problem is not present just in the countries of the southern wing of the EU but it also affects Germany and France where the debt ratio increased by approximately 20 % of GDP during the Great Recession.

Strict adherence to fiscal rules in the first seven years of the past decade might have probably helped the Euro area avoid a debt crisis. However, strict compliance to the fiscal rules by the current levels of debt may lead the more indebted countries to a position similar to that of Greece which (even after the debt haircut and implementation of fiscal reforms) is generating primary budget surpluses but where its debt / GDP ratio has increased to a staggering 177% due to the decline in GDP (Zettelmeyer, Trebesch, Gulati, 2013)

Economic theory and the theory of economic policy know several alternative pathways how to reduce debt to a level that would not limit economic growth. These are: (i) reduction of the relative value of debt due to higher inflation or (ii) default and debt restructuring associated not only with changes in maturity of the debt but even with partial haircut of the debt burden. As indicated in Miller and Thomas (Miller, Thomas 2013) approximately 190 cases of restructuring of sovereign debt associated with the exchange of debt and its partial forgiveness can be found in the world only from 1950 to the present. The size of the haircut varies within a wide range though. Oosterlinck (Oosterlinck, 2013) reported the range of 13-78 % of the original value of the debt. The variety of ways of restructuring is actually very wide, particularly in the way of its realization. Because there is no universally accepted international bankruptcy law on public debt, each solution chosen has basically been original (Moody 2013). For the purposes of this article, we use the subdivision proposed in the article by Miller and Thomas as a possible solution for the Eurozone. These are the options: (i) creation of a comprehensive legal and institutional framework for dealing with state bankruptcy (for the Euro area the European Crisis Resolution Mechanism is suggested), (ii) the purely contractual or "market driven" approach to sovereign bankruptcy, (iii) One-time solutions for some form of a "supranational special purpose vehicle" or (iiii) taking on the federal level and fiscal centralization (the formation of common federal budget as mentioned in: Bargain, Dolls Fuest, Neumann, Peichl, Pestel 2013)

As can be inferred from the current developments in the Euro area the first and the fourth option are not politically feasible. The existing solutions for countries with problems (especially in Greece and Cyprus) were finally - as an ad hoc response to a problem being approached way too late – a combination of contractual (or market driven) solutions with "statutory intervention" when supranational institutions enforce and coordinate a way to deal with the situation when it already was "too late".

Paris and Wyplosz (2014) suggest a sophisticated, yet relatively simple way how to (hopefully) make it politically possible to create a supranational special purpose vehicle and to avoid the problem of moral hazard where less responsible governments produce excessive amounts of new debt.

This proposal is based on the assumption that it is possible to plan an orderly debt restructuring in the Eurozone without any redistribution among countries. A creation of an SPV (which may be ECB) is also a part of this proposal. This SPV would take over the existing public debt at nominal value and convert them to a zero return perpetuity. The SPV raises capital in the public markets to buy these government bonds and repays their interest. This generates a loss in the range of the interest. Seigniorage may be used to pay this loss. The main, and only, merit is that a portion of public debt is not traded any more.

„The way to eliminate politically unacceptable inter-country transfers is to require that the agency acquires and swaps public debts of all Eurozone member countries in proportion to each country's share of its capital, which determines how profits and losses are passed on to governments. This feature means that, over time, each government will 'pay back' the agency, over the indefinite future, the total amount – in the present value sense – of the initial debt cancellation in the form of reduced distributed profits. The debt restructuring thus amounts to a transfer of the debt burden from current to future generations within each country, without any transfer from one country to another or from current debt holders." (Paris, Wyplosz 2014)

Then the crucial issue of moral hazard appears. The proposal specifies that, should a country accumulate debt again, the agency is obligated to swap the zero-interest national perpetuities back into interest-yielding bonds. Such an action which is bound to trigger strong market reactions, should deter governments from sliding again into fiscal indiscipline.

Conclusion

Europe is suffering from a very high level of public debt, which threatens the stability of the banking sector and undermines economic growth. There are several ways how to eliminate this risk - higher inflation, various types of state bankruptcies, federalization of Europe and takeover of the debt by a common fiscal authority or an institutional solution that requires only minimal adaptation of the existing institutional structure of the EU. The latter one being a permanent "burial" of the excessive part of current debt on the balance sheet of the ECB. Under certain conditions it is possible to design this solution as non-inflationary and by exclusion of the risk of future moral hazard in public debt incensement.

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Contact

Stanislav Šaroch

Škoda Auto University

Na Karmeli 1457, 293 01, Mladá Boleslav

stanislav.saroch@savs.cz