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Resolving the Eurozone Debt Crisis

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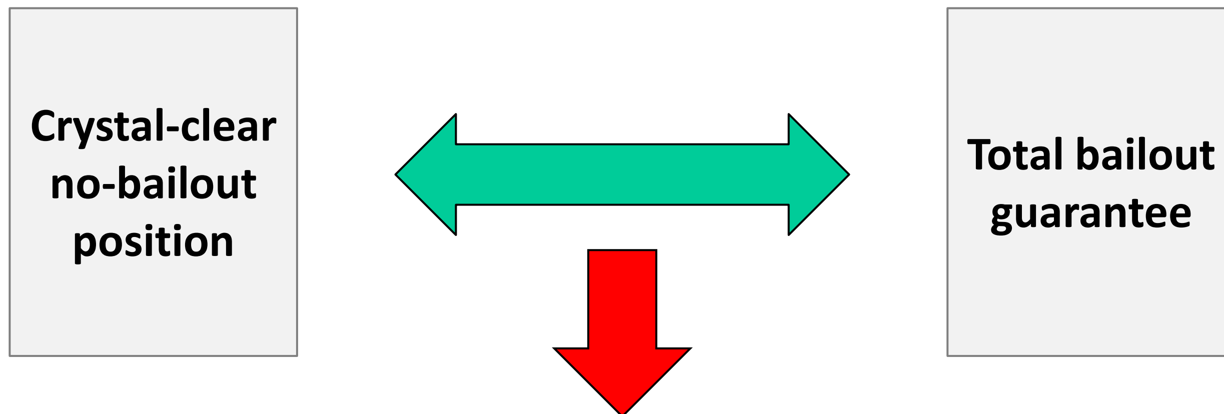
Stuck in the middle ...

... the worst place to be



Markets are faced with extra “rescue risk” (guess about intentions of EU/IMF officials and future lobbying success)

Restoring market mechanisms (1)

- Negation of sovereign insolvency eliminates basic idea of risk premia
  - 2 % risk-free interest rate
  - 50 % haircut (neutral to final value) every …

    … 72 years (100 bps risk premium)

    … 36 years (200 bps risk premium)

    … 24 years (300 bps risk premium)

⇨ Sovereign insolvency framework for (re-)establishing credible risk-awareness

⇨ Equity cushion for sovereign bonds

Restoring market mechanisms (2)

- Permanent intra EA balance of payments financing via ESCB (Target2)
  - 25 % of monetary base issued by CBs of Greece, Portugal, and Ireland (6 percent of EA GDP)

- Capital markets are out of the game (no market-based credit sanctioning)

⇨ Reinforcing temporary (clearing) character of Target2 system

Spill-over effects?

- Greece is different
  - Ad hoc "correction" of deficit figures
  - Extremely high debt-to-GDP ratio, high (unsustainable) debt servicing burden
  - Poor attractiveness for FDI, small degree of openness, low investment ratio
  - Doing Business Index (World Bank): #109

⇨ Large distance even to "next" candidate Portugal

Contagion and multiple interest rates

- Investor confidence matters
  - Greek bailout itself negatively affects the fiscal position of other EA countries
- Maturity structure matters (roll-over risk)
  - Long-term financing comes with extra cost …
    … and extra benefits
    (insurance fee against solvency crises)
  - Short term borrowing only looks cheaper

Financial stability

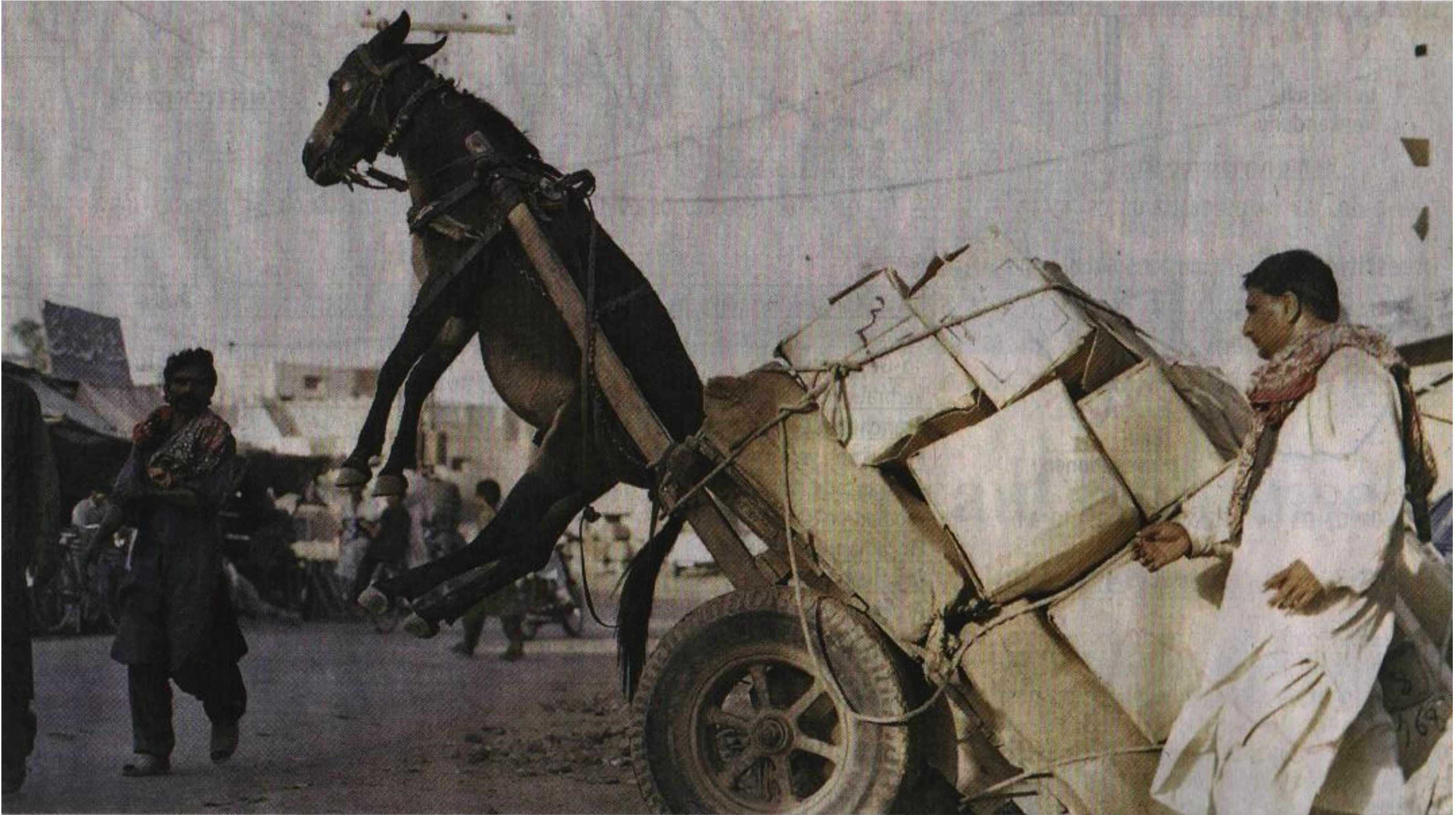
- Principle of Financial Subsidiarity
  - Level 1: Full mobilization of private loss absorption capacity (no "voluntary" participation)
  - Level 2: Full mobilization of national "bail-out" capacity (compulsory recapitalization)
  - Level 3: European rescue facility
- Strengthening banks' equity buffers
  - Differentiated ECB refinancing conditions (~ absolute equity position to avoid deleveraging incentives)
  - Contingent convertible capital (debt which converts into equity once a certain trigger is breached)

Role of EFSF

- Euro Area wide rescue net for banks, not for governments
- Limited capacity (440 bn)
  - 109 bn Greece II (79 bn with IMF package)
  - 26 bn Portugal
  - 18 bn Ireland

  ⇨ 287 (317) bn available funds (= 28 weeks of current ECB purchasing programme)
- Funds should be used exclusively for (compulsory) recapitalization of banks
  - Insurance model comes with wrong incentives
  - Leverage puts further stress on EA member states

Levered out



Source: FAZ, 26 October 2011, p. 11

Key direction

- European Central Bank
  - Last remaining institution with sufficient credibility
  - Bailout via CB looks cheap … until it is too late
  - Current sterilization is not neutral
  - Supra-national architecture without centralized fiscal counterpart strengthens independence
- Significant limitation on the fiscal sovereignty of member states
  - Self-restraint: Fiscal rules, debt commissions
  - EMU regulation (fiscal union)

⇨ **Back to Maastricht**