Yves Mersch: Current challenges in the sovereign debt crisis

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the SWF (Sovereign Wealth Fund) Forum, Montreux, Switzerland, 24 October 2011.

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Ladies and Gentlemen,

It is my pleasure and privilege to talk in front of this audience of experts and practitioners. I do thank the SWF Forum for this opportunity to share my thoughts on the current challenges of the sovereign debt crisis in Europe.

Montreux seems to be the perfect setting for a central banker to speak. Is there a better symbol for stability and long-term nature than the surrounding Alps? And Lake Geneva represents a perfectly balanced level of liquidity – while central bankers have to deal with the contradiction of abundant global monetary liquidity and a shortage of market liquidity in certain asset classes.

But without further ado, let me embark in today's topic.

Need for clarification: the often forgotten strengths of the euro area

Some countries in the euro area face a combination of high levels of indebtedness, budget deficits and weak or absent growth. Amid growing market turmoil and the risk of contagion an increasing number of economists call for debt restructuring in the affected countries. These proposals often share an anti-Euro sentiment and seem to be in accordance with the naysayers who were taking potshots at the Euro even before its inception in 1999.

However, many critics ignore the euro area's strengths. There is a need for clarification. Let me start by stressing some facts:

1. Since its inception almost 13 years ago, the euro area has experienced an unprecedented level of price stability.
2. The euro area has logged real per-capita income growth of around 1 percent a year since 1999, just below the U.S.'s 1.1 percent. Observers often look only at headline growth figures, where the difference is bigger. But the figures match once adjusted for population growth.
3. During the same period of time, the euro area has created 14 million jobs, six million more than the USA.
4. Contrary to common belief, the heterogeneity within the euro area is not significantly bigger than between U.S. states.
5. On a consolidated base public finances are in a much better shape than those of other major currency areas. The euro area as a whole will run a budget deficit of about 4.5 percent of gross domestic product this year. The International Monetary Fund (IMF) expects a U.S. budget shortfall of about 10 percent this year.
6. According to the IMF the aggregate debt-to-GDP for the euro area stands at 87 percent. For the US the debt-to-GDP ratio in 2011 is expected to be 100 percent.
7. The current account is broadly in balance, different from other advanced economies of similar size. For this year the IMF forecasts a current account deficit of 3 percent for the U.S.

Still, there is no room for complacency. The sovereign debt crisis in several Member States of the euro area and financial markets turmoil indicate that we are facing very challenging times.

Currency without a state

The above mentioned figures are publicly available and communicated by the ECB and the national central banks of the Euro system on a regular basis. Why then, one may ask, are markets still so suspicious? The main reasons lie in the specific set-up of a currency regime without a government in general and the euro area in particular. Although the euro area has a centralized monetary policy, fiscal policy is still in the hands of national authorities. Several problems arise in this context. Let me highlight just one of them:

There can be the case for moral hazard in so far as fiscal profligacy of one single member state could be averaged out by the virtuous behavior of the majority of the other countries. The incentive structure is flawed because it can lead to unsustainable fiscal policies of individual member states which in turn would generate negative spill over effects to the monetary union as a whole.

The founding fathers of the euro area were aware that the management of a single currency in a union of sovereign states would be challenging and that effective rules were required to safeguard the credibility of the currency.

At the very core of that framework the no-bail-out clause and the Stability and Growth Pact were installed. The first should have excluded free rider incentives and the second should have aligned national fiscal policies to prevent negative spill over effects to the currency union as a whole.

But the global financial crisis with its consecutive phases has disclosed the weaknesses of that institutional set up. The financial crisis with the epicenter at the US subprime mortgages markets erupted in August 2007. After its dramatic deterioration in September 2008 it turned into a sovereign debt crisis in spring 2010. The pre-crisis situation of public finances differed in the various countries of the euro zone, sometimes significantly. Regardless of whether private debt has been socialized or the problem was from the beginning in public finances itself, the outcome was a drastic increase in the public debt burden. The financial aid packages for stressed banks and fiscal and social stimulus programs to combat the recession disclosed painfully the limits of the financial capacity in some countries.

With hindsight we have to acknowledge that some countries allowed fiscal profligacy, weaknesses in the banking sector and deteriorating competitiveness. The institutional setup could neither prevent nor resolve a severe crisis of the magnitude that we are currently experiencing. Although, the instruments and procedures were available, they were not implemented, ignored, or watered down.

In a nutshell: the euro area suffered from serious weaknesses in the fields of financial, fiscal and economic governance on the preventive side and had lacked a crisis resolution mechanism.

Sovereign default is no panacea

The current situation is characterized by widespread instabilities, the contagion of stress from smaller to larger countries threatening the financial system as a whole. To solve the problem, a number of voices call for debt restructuring in the affected countries. These calls for default tend to ignore some severe obstacles. Let me mention some of these.

The default of a company or even a private household cannot be compared to a sovereign default. As Governments have to discharge duties of public interest they cannot be dissolved via an insolvency process as how it is practiced with a distressed corporation. The demand for public goods will remain; the need to provide them likewise.

Moreover, for firms in severe financial distress it is common practice to pass some of the burden from the debtor to the creditor to arrange a settlement among the parties involved. Both, debtors and creditors alike share an incentive to do so. The liabilities of the debtor decrease and the creditor – compared to a fully fledged insolvency – reduces losses. The private creditor might benefit in relative terms from a bail-in. He therefore can agree upon rescheduling a loan or converting debt into equity.

The problem with the sovereign case starts with the blurred distinction between solvency and liquidity of a country. The question whether a company faces the threat of insolvency can be answered relatively clearly. Its assets and cash flow can be compared to its liabilities and the chances of cost containment and generating additional funds to tackle the threat of insolvency.

For a government things are more complex. Like a private firm a state can reduce its costs and spur revenues when liabilities exceed assets and revenues. But governments can do more. On top of the privatization of publicly owned assets, public expenditures can for instance be diminished by cutting the salaries of civil servants and public employees – a far more difficult task for a private company.

Beyond the public budget and the value of marketable assets a government can increase revenues by levying taxes. The entitlement to tax is unique to the state and grants access funds and means from an owner without the duty of compensation. By consequence, a government with liquidity problems has much more leeway to avoid default.

All this, of course, relies heavily on the political will of the government and capability of the administration. The feasibility of such measures in turn depends to a huge extent on the people's attitude, i.e. in particular the willingness of the social and economic elites to pay for the state. Cultural and social issues clearly play an important role here.

To sum up, the concept of insolvency as an objective inability to pay is not an operational concept for sovereign debt.[1]

Still, for a highly indebted country it apparently seems attractive to lower the debt burden by default. Such a political decision is based on the assessment of the balance of benefits and costs. To make it clear: the disadvantages outweigh the advantages of that sweet-seeming but poisoned temptation.

– The defaulted sovereign will lose access to international capital markets as a consequence of the ultimate loss of credibility.
– The assumption that a sovereign default would abolish the need for austerity measures is misleading. At least countries with a primary deficit – the rather normal case for a country in financial distress – will still have to consolidate its budget.
– Strong repercussions on national income are to be expected due to the negative wealth effects, capital outflows and trade disruption.
– The domestic banking sector will suffer due to necessary write-offs on the affected government bonds. Domestic banks tend to hold those as major creditors. Financially stricken banks might cause a credit crunch, restricting the access of the real economy to funding. A negative feedback loop might be generated.
– The international financial system will be jeopardized, in particular in times of increased insecurity and market volatility. International market turmoil might trigger a negative loop affecting the domestic economy of the debtor country.

Legal considerations and empirical evidence

On top of these economic arguments, legal aspects have to be taken into account. Different from individuals and firms, in the absence of war a sovereign country cannot be forced to

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1 See Hellwig, Martin (2011), p. 63.

fulfill its financial duties. Given that restriction, a global consensus has build that contracts and obligations between nations have to be binding although they are merely based on trust. The sovereign signature is the supreme symbol of a countries legal system. To breach an international agreement puts the credibility of the whole country in question, including its legal and economic system.

These legal issues might not matter in the ivory towers of contemporary economists. In reality, however, markets can only function properly when they are embedded in a sound legal framework. During the 1980s and '90s parts of Latin America and several countries of the former Soviet Union experienced severe social frictions when they were exposed to the dynamics of pedigreed free markets without the prior set-up and implementation of a sound legal system.

Beyond this theoretical reasoning there is empirical evidence a sovereign default is no panacea for heavily indebted countries. Although there are individual cases in which restructuring was manageable and to that extent successful, these cases are rare.

By contrast, most of the times restructuring of sovereign debt was disorderly, devastating and time consuming. The average length of the negotiations was 2½ years with the durations varying greatly. While sometimes negotiations have taken just a few months like in Uruguay in 2003, in Pakistan in 1999, in Chile in 1990 or in Romania in 1983. In other occasions it took many years to return into calmer waters, for example in Vietnam from 1982 until 1998, Jordan from 1989 to 1993, Peru from 1983 to 1997 and Argentina more recently.[2]

All these reasons represent the foundation why Governments try to avoid a default by all means. By consequence sovereign bonds – in particular in industrialized countries – are generally regarded as a largely risk-free investment. They form the basis for the risk free rate not being backed by equity. As such they are also the anchor for many transactions and valuations in the financial sector.

The particular case of a monetary union

The above mentioned arguments also apply to a monetary union like the euro area. But there are additional particularities.

1. Due to the high level of integration in financial markets and trade, there is an elevated risk of contagion in case of a sovereign default in the euro area. The potential consequences for banks that would need to write off parts of their assets would be severe. Negative feedback loops to the real economy were likely.
2. The incentive structure might become flawed. Moral hazard could be aggravated with regard to the borrower. If a Member Country knows that it does not have to fully service its contractual liabilities obligations but instead restructure its debt, it may be tempted to accumulate excess levels of debt.[3]
3. The credibility of the monetary union as a whole could be scratched. If investors paint the solvent member states with the same brush, risk premia on sovereign bonds would rise sharply affecting the whole specter of credit.
4. Last but not least, there are legal considerations. Generally, if a government does not service its financial obligations it breaches its legal obligations (independent of the effective lack of enforceability by the creditors already mentioned). In the case of the euro area there is an additional trait. Article 126 paragraph 1 of the treaty (which is binding for all EU countries not only those whose currency is the Euro) clearly

[2] See Bini Smaghi (2011); Reinhard et al. (2003); Ozler (1993).

[3] See ECB Monthly Bulletin (10:2011).

states that a Member State "shall avoid excessive government deficits". Although there is some scope for interpretation what "excessive" means it can hardly be doubted that a deficit that leads to a sovereign default was ultimately excessive.[4]

Working for the better: Closing the implementation gap …

These sound arguments call for the avoidance of a sovereign default by all means. But what is to be done instead?

The superior avenue is a combination of crisis resolution to curtail the panic and prevention measures to regain confidence.

In more detail this means:

1. Those countries under the rescue umbrella have to fully implement the conditions of the respective programs in order to return to a sustainable level of debt and regain competitiveness. During the adjustment process they receive financial aid from the Luxembourg based European Financial Stability Facility (EFSF). In order to eliminate any doubts on the sufficient fire power of the EFSF, governments of the euro area Member States should provide appropriate leveraging of the fund – not to be confounded with monetization. It is also important that the EFSF operationally can intervene in the secondary markets as soon as possible to tackle fundamentally unfounded distortions in the sovereign bonds markets. These distortions hamper the smooth functioning of the single monetary policy stance.
2. Macroeconomic imbalances and unsustainable fiscal policies must be avoided in the future. Prevention is key. The recent agreement reached by the European Parliament and the Council on the "Six Pack" is a step in the right direction. The Stability and Growth Pact has been strengthened; imbalances and competitiveness will be monitored at an early stage. But this economic governance package falls short of greater automaticity in decision-making that the ECB has long advocated for.

For the time being, the implementation gap must be closed. Most of the above mentioned proposals are mirrored by decisions that have been taken already. As soon as possible the new governance rules must be applied completely and rigorously. Moreover, the governments of the euro area member states must implement all the decisions of the EU summit of 21 July. Swift implementation is a necessary condition to resolve the confidence crisis the euro area currently faces.

… but being prepared for the worst: increasing resilience and ring fencing

Nevertheless, if a countries debt burden becomes unsustainable, a restructuring of sovereign debt cannot be excluded as ultimate resort. To be prepared for the worst, several lines of defense have to be strengthened:

1. In order to mitigate foreseeable tensions in the financial industry, banks have to clean their balance sheets as quickly as possible. They need to build up a stronger equity position by retaining profits and moderation in remunerations, bonus payments in particular. Preferably they can search for recapitalization via capital markets. If this is not feasible, Government must step in to recapitalize solvent banks. Where it would be necessary, the EFSF can be approached to recapitalize banks.

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[4] See Siekmann, Helmut (2011).

2. It must be crystal clear that in the unlikely case of a restructuring of one country, this would be a unique case. The impression that restructuring was a standard instrument of the crisis management tool kit must be avoided by all means. In order to do so, countries with elevated debt levels would have to speed up their consolidation efforts to send out signals of credibility to the markets. Sound and credible public finances are the best way to ring fence from markets suspicion.

In any case it is advisable to avoid any restructuring that is not purely voluntary or that shows elements of compulsion, and to avoid any credit events and selective default or default. Rather, the Member States of the euro area need to demonstrate their determination to their own individual sovereign signature, in order to ensure financial stability in the currency union a whole.[5]

Concluding remarks

The epicenter of the global financial crisis has shifted from the US to the euro area. The rapid spreading of the crisis is reducing the options at hand to tackle the crisis.

Europe has already taken important decisions to improve its crisis resolution mechanism and to strengthen preventive measures to avoid macroeconomic imbalances and unsustainable fiscal policies.

It is important to implement these rules now and make the institutions operational, as markets tend to lose patience. There is a strong appetite for a comprehensive solution.

The banking sector must increase its resilience against sudden, external shock. This is particularly important in times of high market volatility and elevated uncertainty. Quick action is needed to clean up banks' balance sheets and recapitalize them, where it is deemed necessary.

On top, countries with elevated debt levels and augmented budget deficits have to put public finances on a more sustainable path and spur growth by structural reform. Sovereign defaults should be avoided as the cost most likely would outbalance the benefits by far. The ECB has repeatedly objected to all concepts of debt restructuring that are not purely voluntary or that have elements of compulsion; any credit events and selective default or default should be avoided. A strong and transparent commitment to sound public finances is the best weapon to combat market attacks.

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Thank you for your attention.

5 See ECB Monthly Bulletin (10:2011).