"Exit the crisis(?)

Daniel Gros, CEPS

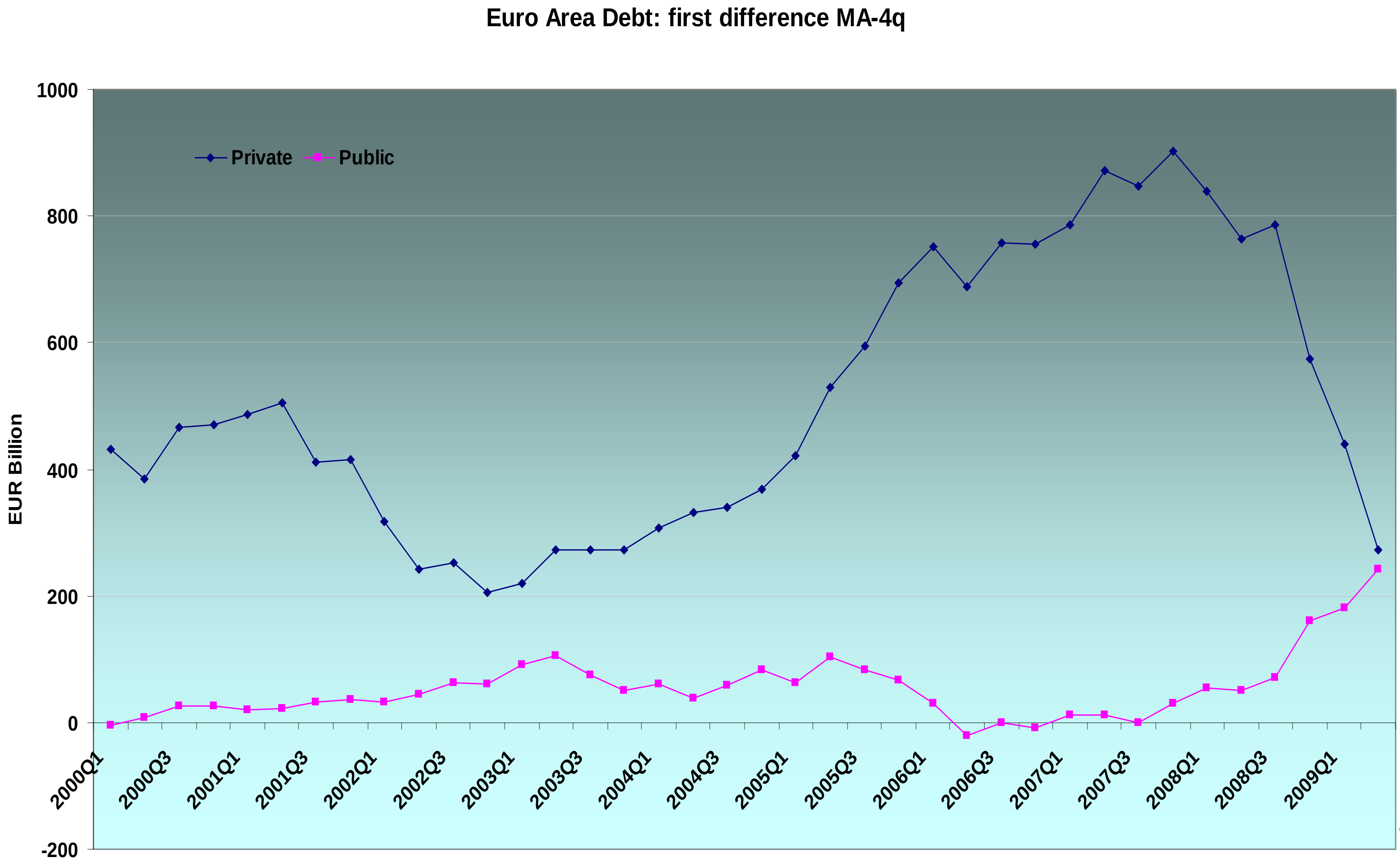
Outline:

- Nature of crisis
- What should be done?
  - Cleaning up the financial sector
  - European Monetary (Stability) Fund
- What will be done?

Nature of crisis

- ‘Greek’ or sovereign debt crisis?
- Misnomer like ‘sub prime’.
- Key: credit boom leads to excess leverage.
- Those with most rapid credit expansion = sub primers = sources of losses.
- Losses limited compared to GDP, but deadly for fragile financial system.

Euro Area:
Private & Public Debt



Leverage in Euro Area (=debt/GDP)

	Corporate	Government	Financials*	Total economy
1999	67	74	155	345
2007	92	69	225	446
2009q2	101	82	241	488
Delta 07-99	25	-5	69	101
Delta 09-2007	9	13	16	42

Nature of crisis

Usual boom bust

- First stage: after the bust private debt becomes public debt

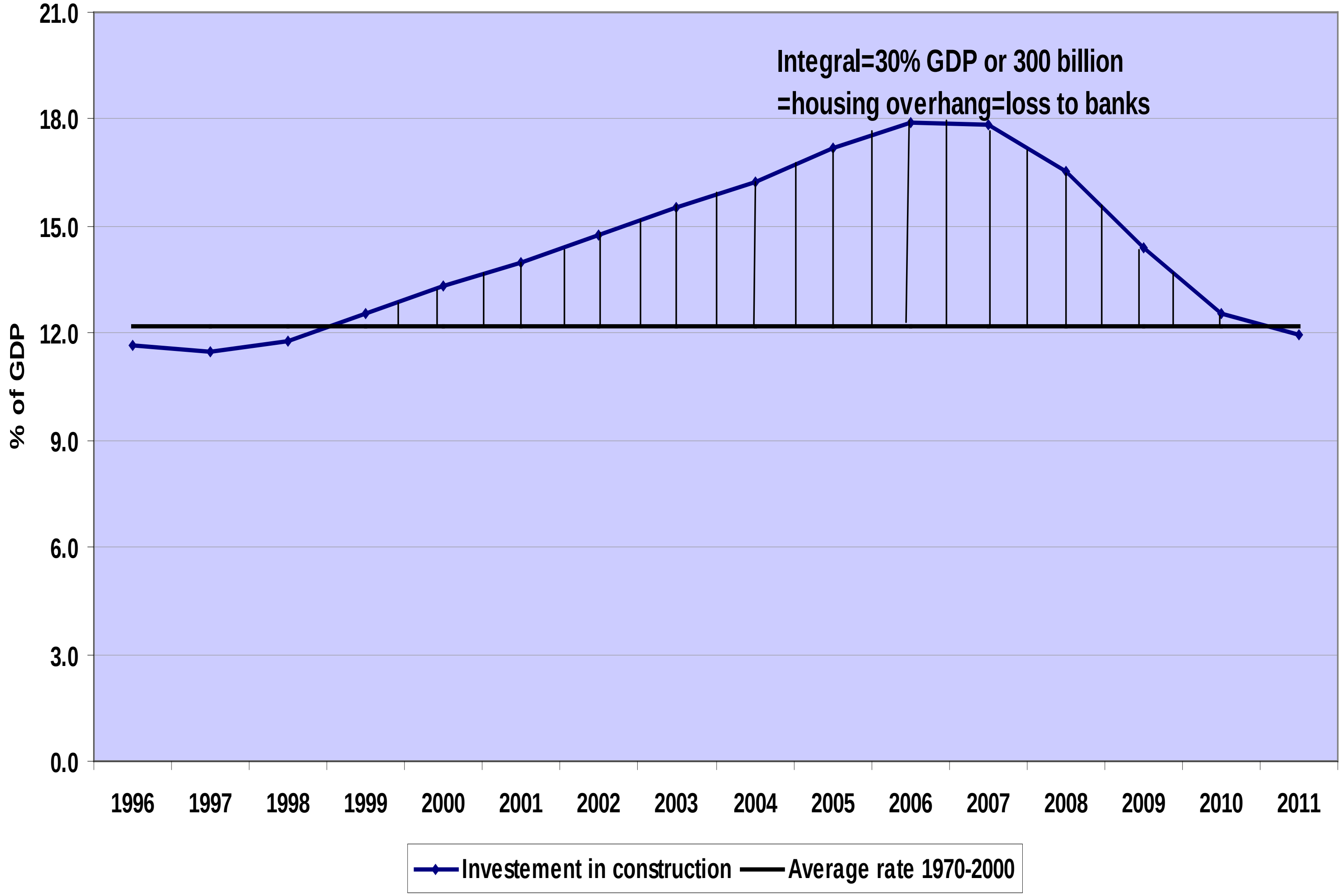
- Second stage of crisis: Increased probability of sovereign default

Nature of crisis:

Bust shows likely losses.

- A priori limited:
- Greece: Total government debt 300 billion => likely loss +/- 150 billion, less than 2 % of EA GDP.
- Spain: Housing overhang = losses of credit to real estate sector.

Spain: construction overhang



Nature of crisis:

Spain: classic over-lending to real estate sector, which will show up in government debt (unless unsecured creditors forced to accept restructuring).

- => Either government in Spain up, or banks (Spanish and others) take hit.

Short run action:

Need stress tests + ‘triage’ in banking sector.

Both for losses in Greece and Spain (+ other real estate bubbles).

Only then can force reduction in leverage and limit damage to public finances.

European Monetary (Stability) Fund

1) Pre-empt the end game:

Recognize sovereign default as possibility

2) Financing mechanism to limit moral hazard

ESF:
Financing mechanisms

- Limit moral hazard
- Extra levy on countries that breach Maastricht criteria :
  - 1% of excess debt:

    actual debt (%GDP) – 60%

  - 1% of excess deficit:

    actual deficit (%GDP) – 3%

Orderly default & haircuts

- Prepare for sovereign default and minimize its cost
- ESF could offer debt holders exchange of the debt, with uniform haircut, against claims on the ESF
  - Haircuts: ESF would buy public debt of the defaulting country (only up to 60% of GDP?)
- ESF acquires claims against defaulting country
- Default on ESF means leaving **€** and ultimately EU

Professional staff and independence

- Commission/Euro Group failed to present a proper adjustment programme
- Staff of ESF would be independent and make assessment free of political imperatives

Concluding remarks

- Clearly need systemic solution to this sort of crisis also in long-run perspective (Euro Area 28 members, many small with untested political systems)

- Merely strengthening Stability and Growth Pact useless

- Policy should not only aim at preventing failure, but also at preparing for it

Thank you

The Clash of civilizations

"Merkel" (= North(?))	"Trichet" (= South)
Article 125 no bail out "Monetary union cannot become a transfer union" ⇒ Failure of a member state is an option • Tough conditionality • Need rules for orderly bankruptcy	"We are all in the same boat" ⇒ Failure of a member state is <u>NOT</u> an option • No plan B necessary • No floor to rating for collateral at ECB

May 9th.
The Clash of civilizations postponed

Fiscal	“Quasi fiscal”
Article 122 invoked Solidarity in case of difficulties beyond control of member state for PT and ES • 60 billion of EU funding for Greece II style operations • 440 for European Stability Mechanism •IMF cofinancing	ECB intervenes in “dysfunctional markets” for government debt Sterilized Completely discretionary ⇒ Effectively redistribution of risk among member states

Greece: Irresistible force meets irremovable object

Irresistible force	Irremovable object
Two guarantees: 1. IMF/Euro area package (covering financing need for three years) 2. (Monetary) financing of external deficit guaranteed by ECB	Greek political system: “The others should pay” $\Rightarrow$ Limited willingness to accept adjustment measures No ‘national pact’ on: 1. cut in wage costs 2. cut in pensions
Outcome will be decided on the streets of Athens	

No plan B needed?

- Adjustment non unprecedented (Greece did it in early 1990s).
- During turbulent times in Europe
- But mainly tax increases
- This time different (debt level higher)?

Debt:

- Debt sustainability
- Stability Pact was supposed to avoid problem (with 60 % GDP debt and 3% of GDP deficit, 5 % nominal growth)
- Large adjustment required!

Debt, external and public:

Worsening of debt sustainability: Temporary or fundamental un-sustainability?

- Factors behind debt build up
  - Public sector wages
  - Expansion of social expenditure not followed by increase in tax revenue
  - Private sector consumption
- (Political) Feasibility of the adjustment ?

Conclusion for Greece:

- Fiscal adjustment is likely to lead to deep recession

- “Sudden stop” requires ultimately compression of consumption

- Main danger not immediate crisis, but slowly developing of vicious circle
  - new Argentina?

Experience with large fiscal adjustment in EU

Country	PB, adjustment period	Years	PB, start (% GDP)	PB, adjustment (% GDP)	PB adjustment, per year (% GDP)
Denmark	82-86	4	-1.3	10.0	2.5
Greece	89-94	5	-6.0	10.8	2.2
Sweden	93-98	5	-2.5	9.0	1.8
Ireland	85-89	4	-0.9	5.9	1.5
Portugal	86-80	6	-5.8	8.2	1.4
Italy	89-97	8	-3.3	10.4	1.3
UK	93-99	6	-3.6	7.4	1.2
Finland	92-2000	8	0	8.2	1.0
France	93-97	4	-2.4	3.6	0.9
Belgium	81-90	9	-4.3	8.1	0.9

Expenditure cut vs. tax increase

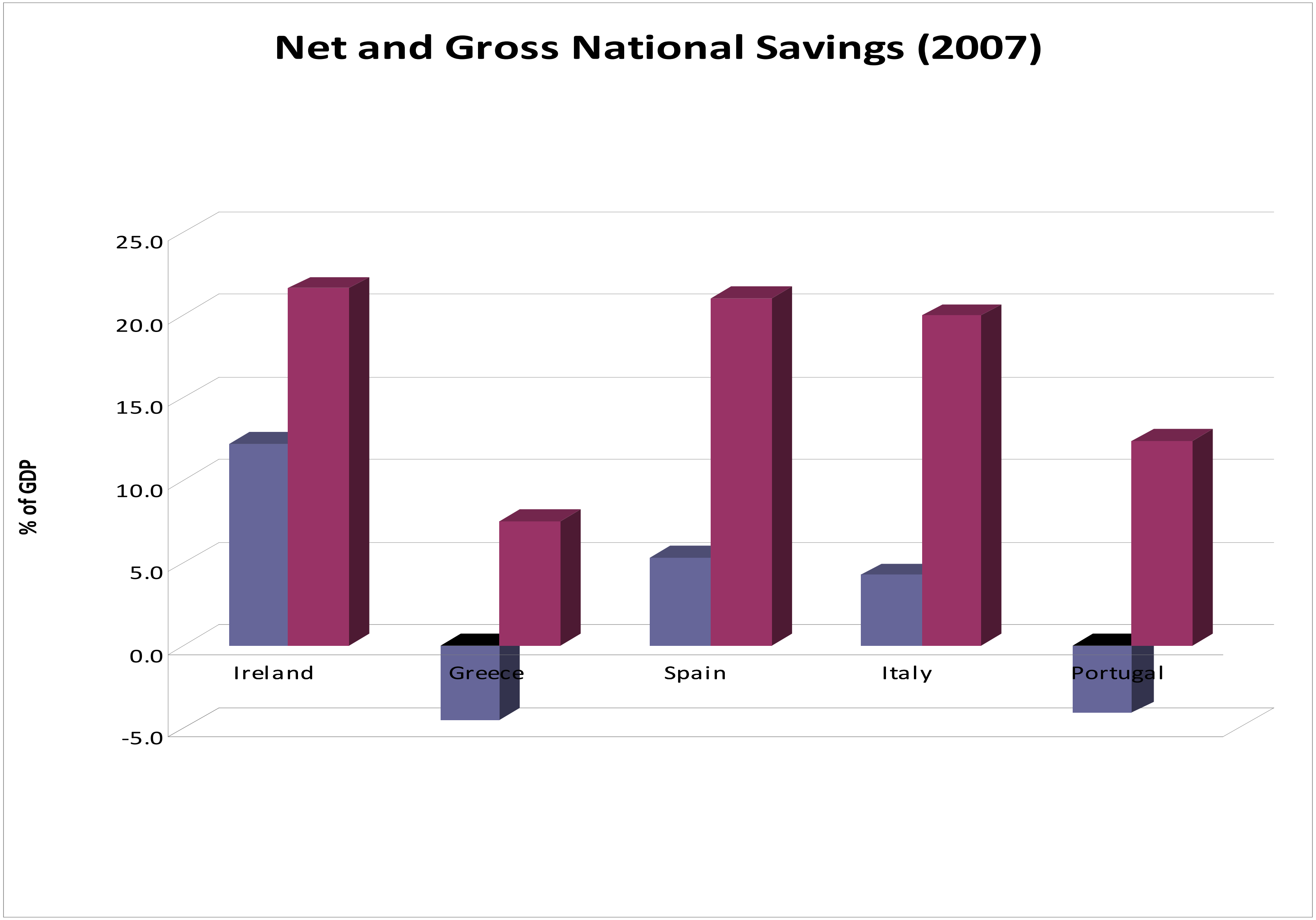
Country	PB adjustment period	% of total PB adjustment through INCREASE IN REVENUE	% of total PB adjustment through CUT IN EXPENDITURE
Portugal	86-80	110.6	-10.6
Italy	89-97	85.3	14.7
Greece	'89-94	84.0	16.0
France	93-97	70.7	29.3
Denmark	82-86	28.2	71.8
UK	93-99	20.0	80.0
Austria	95-2001	12.2	87.8
Belgium	81-90	1.8	98.2

Changes in the snowball factor

	Snowball factor = interest rate minus growth rate	
	2003-2007	2009-2011
Ireland	-3.6	8.8
Greece	**-3.2**	**5.0**
Spain	-3.4	4.6
Italy	0.6	3.2
Portugal	0.3	4.4

Indicators of external debt burden

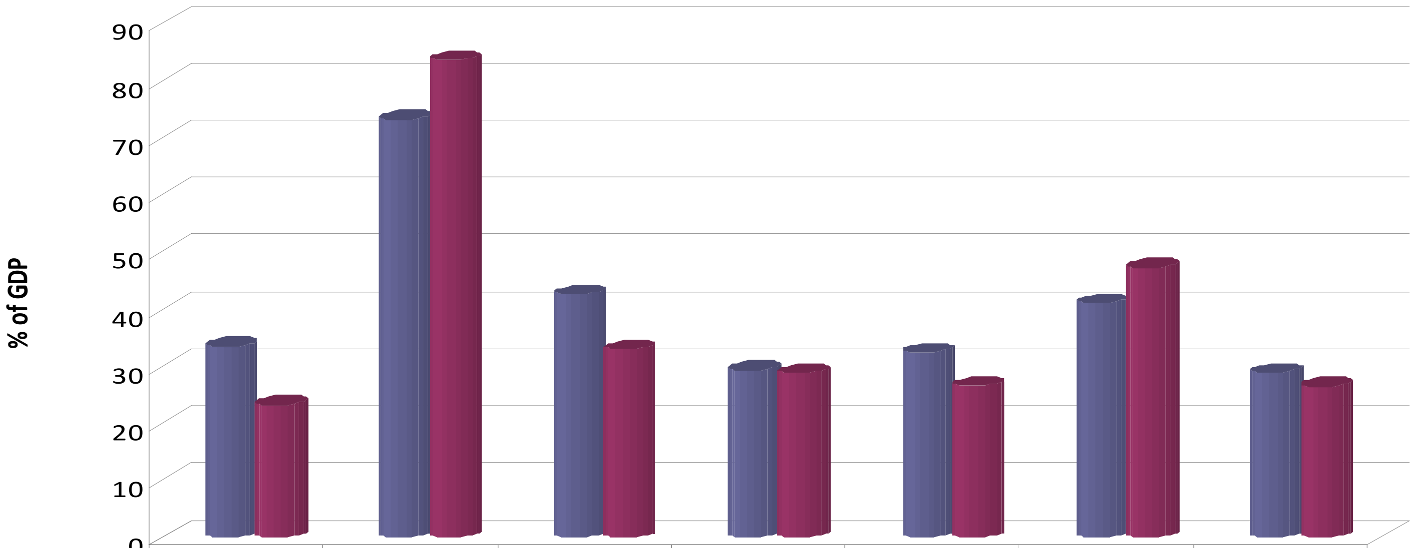
2009q3	Argentina (1999)	Hungary (2008)	Greece	Portugal	Spain	Italy
Total Gross External Debt as % GDP	52	141	167	226	164	121
Total Gross External debt as % of Exports	529	204	832	817	696	513
Government & MA gross external debt as % of Tax revenue	na*	138	329	189	100	124



Net and Gross National Savings (2007)
% of GDP
25.0
20.0
15.0
10.0
5.0
0.0
-5.0
Ireland
Greece
Spain
Italy
Portugal

The degree of openness

Import and Export (goods plus services) 2008



	Greece	Ireland	Portugal	Italy	Spain	Germany	France
Import	33	73	43	29	32	41	29
Export	23	84	33	29	27	47	26

A reminder: Argentina

- Two years and **three** IMF programmes from first trouble to default
- Initially: No **net** external debt!
- But government had foreign debt (private sector foreign assets)
- Popular opposition to fiscal adjustment required to service foreign debt too strong
- Can it happen again?
- Greece: foreign debt all public!

Defaults can happen

And happened in the past

⇒ 0.8% probability every year or

45% over 55 years

Never defaulted (over the period 1900-2006)	**BE, DK, EST, IE, ES, FR, CY, LT, LV, LUX, HU, MT, NL, SK, FI, SE, UK**
Defaulted after 1950	**Bulgaria, Czech Republic, Germany, Greece, Austria, Poland (2), Romania (2)**

Source: S&P Commentary 'Sovereign defaults at 26-year low, little change in 2007'