Dealing with sovereign debt crises: a stronger European toolbox is needed

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Outline

1. Sovereign debt crises and EMU architecture
2. Sovereign debt developments
3. Debt Sustainability Analysis (DSA) in the EU
4. Way forward
EMU today: An unstable equilibrium

1. Incomplete Banking Union and no CMU
2. Insufficient adjustment mechanisms
3. Partial ownership of fiscal rules
4. No common stabilisation function
## Two competing models for EMU

<table>
<thead>
<tr>
<th>&quot;Back-to-Maastricht&quot;</th>
<th>Fast forward to federalist EMU</th>
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<tbody>
<tr>
<td>Stronger enforcement of EU fiscal rules to rein in debt and deficits</td>
<td>Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance</td>
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<tr>
<td>Mechanism of imbalances procedures (MIP) focused on competitiveness of lagging countries</td>
<td>Symmetric adjustment to help weak countries and reduce Euro area current account surplus</td>
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<td>Banking Union does not need common deposit insurance</td>
<td>Full Banking Union to ensure financial stability and private risk sharing</td>
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<td>End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism</td>
<td>Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation</td>
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<tr>
<td>More market discipline</td>
<td>Euro area Treasury</td>
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**In their « pure » form, both are economically and/or politically unfeasible**
EMU reform: the right balance and right sequencing to make no-bail-out rule credible and prevent debt crises becoming systemic

1. Completed Banking Union and severing bank-sovereign nexus: i.e a Pan-European banking sector. This requires SRF backstop, full EDIS, and a genuine, sizeable European Safe Asset if changes to RTSE are to be introduced.

2. A genuine Capital Markets Union: to enhance private shock absorption mechanisms, reduce real economy’s reliance on bank financing, increase private-risk sharing

These reforms will take time - introducing a sovereign debt mechanism in their absence will contribute to financial crises rather than prevent/contain them => outcome: more bailouts
Debt developments – where do we stand?

Public debt developments in EU, US and Japan since 1985 (% of GDP)

Key contributions to change in public debt in EU and US since 1988 (pps. change between 1988-2017)

Source: EC 2018 Public Finance Report, forthcoming
Debt developments in large EU countries

Government debt ratio (% of GDP)

Source: Ameco
A longer term perspective

**Germany**
- Significant debt reduction (at least 2 pps. cumulated)
- Debt-to-GDP ratio
- Baseline debt projections

**Spain**

**France**

**Italy**
- % of GDP
Fostering sustainability – the EU context

EU fiscal surveillance
monitoring & promoting fiscal sustainability

EU Semester
promoting strong & sustainable growth

Sustainable debt
reducing risks

Fiscal Councils
Independent fiscal monitoring

National authorities
domestic economic strategies

Monetary policy
conventional & unconventional (e.g. OMT)

EU backstops
managing crises & sharing risks
The right tool for the job(s) – conceptually

Integrated tool
- Integrates all aspects
- *Highlights all issues*  
  *Including dynamic trade-offs*  
  \( \rightarrow \) *virtuous (& vicious) circles*

Common tool
- Coordinated and clear dialogue across many stakeholders
- Shared ownership
The right tool – in practice

DSA tools have to be multi-dimensional:

- Use various techniques that complement each other
  - E.g. stochastic projection & deterministic projections (with simple/clear alternative scenarios)

- Monitor & analyse different aspects
  - E.g. Gross financing needs, debt profile/structure, financial market expectations (and their impact)

DSA tools should consider trade-offs

- Complexity vs Clarity (communication effectiveness)
- Mechanical vs Use of informed judgement
  - Harmonized across countries (general principle)
  - Tailored-made DSA (under certain circumstance)
  - Pitfall of fully mechanical approaches – e.g. threshold effects

Solution: Provide a clear overall assessment + detailed information (enhanced analysis) + account for qualifying factors
COM regular DSA components – overview (used for EU surveillance)

Risk-classification (S-indicators, debt level & trajectory, realism of fiscal assumption, uncertainties)

Debt profile (currency, holders, maturity)

Contingent liabilities (incl. linked to the banking sector)

Risk-based approach

Other risk factors (e.g. public assets)

Benchmarks derived from early-detection model

Banking sector: simulations based on model (SYMBOL)
### Benchmark values for debt level

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### Debt trajectory

#### Critical thresholds for S-indicators

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<td>5.3</td>
<td>4.7</td>
<td>6.2</td>
<td>9.4</td>
<td>5.7</td>
<td>3.6</td>
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<td>4.8</td>
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### Probability of debt stabilisation

#### Realism of fiscal assumptions

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### Size of uncertainties

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DSA in programme context
*special case & particular challenges*

- **Specific use: programme access and modalities (size, financing terms, conditionalities)**

- **Specificities of the EU/EA context:**
  - Size and maturity of ESM programmes
  - Importance of contagion effects and spillovers (need looking beyond country-specific DSA results)

- **Difficulties of diagnosis:**
  - Increased uncertainties; blurred frontier between illiquidity and unsustainability; sustainability ex-ante versus ex-post
  - Importance of the grey area (debt sustainable but with which probability?)
COM DSA strength: integrated approach

Treaties' provisions and policy recommendations

Council conclusions

Diagnosis

Fiscal Sustainability Report (every three years)
Debt Sustainability Monitor (once a year)
Country Reports (once a year)
Post-Programme Surveillance Reports (once a year)
Ageing Report (every three years)

Stability and Growth Pact
- EDP procedure
- MTO and adjustment path
- Margin of discretion (DBP) SCP assessment

European Semester - Country-specific recommendations
- SGP related
- CSRs related to pensions, healthcare and long-term care

Comprehensive sustainability analysis (regularly updated, including impact of population ageing)
COM DSA strength: dialogue tool

- Regular publications (FSR, DSM, CRs, SCP assessment notes)
- Calculations shared with Member States, Fiscal Councils and other EU institutions
COM DSA strength: comprehensive but flexible

- ‘Enhanced’ DSA available in the COM framework
- Additional customised sensitivity tests provided in the context of regular / post-programme surveillance
- Qualified analysis, based on additional risk indicators, provided in country-specific reports (CRs, PPSRs)
Way forward: potential institutional reforms to DSA framework

A range of institutional reforms to the current European debt sustainability framework are being discussed:

• The interaction of COM and ESM in assessing public debt sustainability when a country requests ESM assistance;

• Possible ESM role in facilitating dialogue between recipient country and its private creditors (along the lines of IMF)

• Potential introduction of single-limb CACs in euro area bonds to prevent hold-outs
Conclusions

• EMU reform must be balanced and sequenced properly to avoid financial instability, with first emphasis on completing the Banking and Capital Markets Union. Work on a genuine safe asset should also be undertaken.

• The debt sustainability framework is one part of such a reform package but a sovereign debt mechanism is not needed and will lead to more bailouts/financial instability.

• The debt sustainability framework should continue to be based on the Commission’s existing comprehensive DSA tools, with the ESM collaborating in areas of expertise.

• There are institutional reforms to improve the existing debt sustainability framework being discussed now.
Thank you very much for your attention