Debt Sustainability in Europe

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Impact of Eurozone Debt Crisis
on East Asian Countries

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A WEEK AGO

The lingering and expanding sovereign debt crisis must be halted to avoid macroeconomic and financial disaster, in the euro area and beyond.

(Jürgen Stark, Member of the Executive Board of the ECB, NY, 2-12-2011)

SUSTAINABILITY INDICATORS

EA as a whole better off than JP & US. Onerous borrowing conditions in some EA countries (e.g. IT) not in line with std sustainability indicators.

	Budget Deficit (1)		Public Debt (1)		Sustainability Indicators		Private debt in 2010		Current balance
	2010	2013	2010	2013	S2 (2)	IMF (3)	Households	Firms (4)	2010
Italy	4.6	1.2	118.4	118.7	2.3	4.1	45.0	81.1	-3.5
Germany	4.3	0.7	83.2	79.9	5.0	4.6	61.6	65.4	5.7
France	7.1	5.1	82.3	91.7	5.5	7.9	55.1	104.7	-1.7
Spain	9.3	5.3	61.0	78.0	12.0	10.4	85.8	140.5	-4.6
Greece	10.6	6.8	144.9	198.5		19.0	60.7	62.9	-10.1
Portugal	9.8	3.2	93.3	112.1		13.8	95.2	152.2	-10.0
Ireland	31.3	7.8	94.9	121.1	15.2	13.5	119.0	185.9	0.5
Euro Area	6.2	3.0	85.6	90.9	6.4		66.3	101.4	-0.5
UK	10.3	5.8	79.9	85.9	9.6	13.3	114.2	100.1	-2.5
US	10.6	5.0	95.2	107.1		17.0	91.7	74.3	-3.2
Japan	6.8	7.2	197.6	215.7		14.3	62.2	96.6	3.6

Sources: IMF, Eurostat, European Commission, national financial accounts, and balance-of-payments data

(1) Source: European Commision - AMECO database

(2) Increase in the primary surplus/GDP ratio with respect to 2010 needed to satisfy the general government intertemporal budget constraint (Source: EU Commission)

(3) Increase in the primary surplus/GDP ratio that must be achieved by 2020 (and maintained for a further decade) in order to bring the debt/GDP ratio down to 60 percent by 2030 (4) Non financial firms only

Main message

1) Mistakes in the design of EMU;
2) gvts circumverting rules (pursuing short term objectives)
3) poor management of the crisis (national and EU)

=>Lack of confidence => Current “Markets Overshooting”

National level – Procyclical fiscal policies :>(

EU level EMU – “Fiscal Compact” :>)

OUTLINE

- EMU in a nutshell
- Lessons from the crisis
- Answers given at the EU level
- Answers given at the national level
  A case study: Italy

EMU

1992: EU countries decide to create a monetary union (Treaty of Maastricht)

1999: Exchange rates of eleven countries irreversibly locked

2002: Euro coins and banknotes replace national currencies

Now 17 countries share a common currency and retain responsibility for fiscal policy (Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland)

Asymmetry between a strong monetary pillar and multiple national fiscal policy-makers asks for **fiscal rules** to :

- prevent moral hazard

- avoid externalities of deficits and debts

- avoid pressures on European Central Bank for *ex ante* & *ex post* bail-out

FISCAL RULES

Fiscal sustainability is a central tenet of Maastricht Treaty

Article 121 requires "***the sustainability of the government financial position***" for a country's eligibility to EMU.

However, the Treaty and the SGP took a **pragmatic approach**:

- rules refer to yearly data
- monitoring refers to short & medium-term trends
- initially, no reference to long-term indicators/prospects

FISCAL RULES

1) **Deficit should not exceed 3% of GDP** unless:

- exceptional events (recessions, etc.)
- excess is temporary
- excess is limited

2) **Close-to-balance or surplus target over the cycle** (medium-term objectives). Following the 2005 reform objectives are now country-specific, depending on the amount of implicit and explicit liabilities and on potential growth

3) **Debt should not exceed 60% of GDP** (if more: decline at satisfactory pace)

4) Multilateral surveillance (stability programs, notifications)

5) Excessive deficit procedure (from recommendations to sanctions)

6) Common statistical framework

SUSTAINABILITY ANALYSIS IN EMU

A large effort to provide expenditure projections - based on commonly agreed demographic and macroeconomic projections

- An **Ageing Working Group** (AWG) has been established including experts from the 27 countries
- In 2001 the AWG released the **first long-term projections covering pensions, health, Long-term Care**. It is updated every three years: the 2009 issue is now available, the 2012 issue is in the pipeline

On the basis of AWG projections, **sustainability gap indicators** for all EU countries are computed (and appear in the annual updates to the stability programmes).

The projections and sustainability reports have made **long-term issues more prominent in the debate**. There are margins of improvement on the technical side (e.g., a better estimate of the cost effects of technical developments in the HC sector, the possibility of higher demand for LT services…).

They are meant to emphasize the long run, and **do not give indications about the short-term vulnerability of the government budget**. This become evident in the current crisis were funding (liquidity) problems are paramount.

LESSONS FROM THE CRISIS

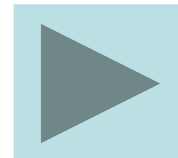
The crisis revealed serious pitfalls in the institutional design of EMU:

1) Fiscal surveillance and discipline were not adequate

2) Macroeconomic and financial imbalances were *de facto* left to the responsibility of national governments; there was inadequate progress on growth-oriented reforms

3) lack of a crisis resolution mechanism

4) Little role for market discipline



INSUFFICIENT FISCAL DISCIPLINE

Fiscal surveillance was only partially effective:

- **Most national governments did no reach their MTOs**. At the outbreak of the crisis many euro area countries had relatively high deficit ratios and debt-to-GDP ratio above the 60 per cent ceiling, in some cases still by a large margin

- if the rules of the SGP concerning the adjustment path to the MTOs had been obeyed on the eve of the crisis the ratio of public debt to GDP would have been over 10 percentage points lower in the euro area and 30 points lower in Greece

- In 2003 the European Council stopped the EDP procedure from being rigorously applied to Germany and France. In 2005, the Pact was softened

- Fiscal profligacy in Greece was not timely reported in official fiscal data (the estimate for 2009 deficit, at 5.1 per cent in April 2009, was progressively revised upwards to 15 per cent)

MACROECONOMIC IMBALANCES

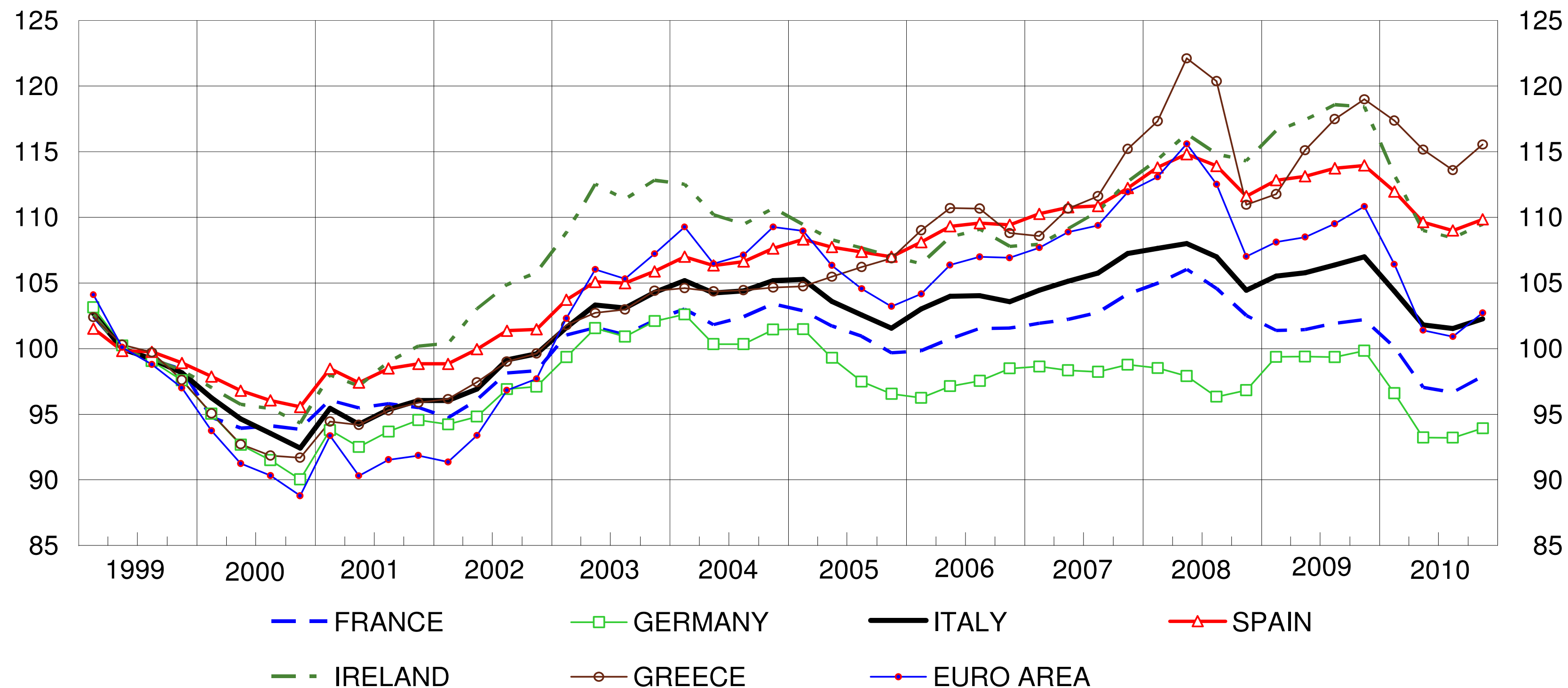
- The crisis has shown that **fiscal surveillance is not enough**
- In a crisis, private liabilities can quickly turn into public debt
- During downturns, macroeconomic imbalances can significantly amplify the worsening of public finances
- **Financial market tensions also involved countries that before the crisis did not exhibit sizable fiscal sustainability problems**
  - Ireland and Spain had both a surplus in 2007, but their deficit ratio increased respectively by 14 and 13 percentage points in the following two years (more than twice the worsening in the euro area)
  - Both countries had significant internal and external macroeconomic imbalances, stemming from a strong credit expansion linked to an unsustainable growth in the real estate sector. In the Irish case, the situation was worsened by the decision of the Government to provide unlimited guarantee to the banking system

INSUFFICIENT PROGRESS ON PRO-GROWTH REFORMS

Since the 1990s, the euro area has grown on average by almost 1 p.p. less than the U.S.

The evolution of competitiveness has been very heterogeneous across euro area countries

Indicator of competitiveness for the main euro area countries (Index 1999=100)



ANSWERS GIVEN AT THE EU LEVEL

Reforms are ongoing in three main areas:

1. Policy coordination

Strengthening the Stability and Growth Pact

Prevention of macroeconomic imbalances and growth-oriented reforms

2. Crisis management

Bilateral loans - the *European Financial Stability Facility* (EFSF) => permanent *European Stability Mechanism* (ESM)

ANSWERS GIVEN: THE REFORM OF THE SGP

Statistical surveillance has been strengthened

Preventive arm: **introduction of an *expenditure rule*** (it aims at avoiding the use of revenue windfalls to satisfy the 0.5 structural balance improvement) make the preventive arm more effective in discouraging pro-cyclical policies in good times

Corrective arm: **introduction of a *debt rule*** (the unsatisfactory reduction of the debt triggers EDP) to make the debt criterion (debt/GDP ratio below 60%) operational. The debt rule puts an additional constraint on high debt countries, as originally meant in the Maastricht Treaty

Enforcing system:
New sanctions:

a) possibility of interest-bearing deposit before entering EDP
b) non-interest-bearing deposit when the EDP is started
***c) reverse voting* system**. Reverse voting can reduce the possibility of collusion within the Council

Given the circumstances, changes have not been sufficiently ambitious, procedures should be made more automatic.

ANSWERS GIVEN: SURVEILLANCE of MACROECONOMIC IMBALANCES and THE EURO PLUS PACT

Multilateral surveillance is extended to macroeconomic imbalances

Alert mechanism based on a limited set of indicators (scoreboard: price and cost competitiveness, private and public sectors debt, external position, …) for which critical thresholds have to be assessed

If presence/risk of imbalance => recommendation
If the imbalance is "serious" => Excessive Imbalance Procedure
If country does not follow the recommendations => yearly sanction (0.1% PIL)

The pact is a commitment of EA (+ some EU) gvts to strive to strengthen growth and competitiveness

It calls for reforms in several areas, including: A gradual reduction of taxation of labour income; an increase in the effective retirement age, where needed; the transposition of the European fiscal rules into national legislation; closer tax policy coordination and, in particular, harmonization of the corporate tax base

ANSWERS GIVEN: CRISIS RESOLUTION MECHANISMS

Financial assistance was granted to European countries experiencing severe difficulties in accessing the market at sustainable conditions; it is sheltering them from **market volatility** and alleviating tensions over their sovereign debt.

To reduce moral hazard in beneficiaries, loans disbursement is subject to **strict policy conditionality** and to the implementation of an agreed **macro-economic and fiscal adjustment program**

The **Greek program** took the form of **bilateral loans** agreed in May 2010 and amounting to 110bn to be provided by the euro-area Member States (80bn) and by the IMF (30bn) over the period 2010-2013.

Financial assistance program to **Ireland** was agreed in November 2010 for a total 85bn to be disbursed over the period 2011-13.

Last May also **Portugal** was granted financial support designed to cover financing needs up to 78bn over the period 2011-14.

ANSWERS GIVEN: CRISIS RESOLUTION MECHANISMS

The **European Financial Stability Facility (EFSF)** is a **limited company** whose shareholders are the euro-area Member States.

The EFSF issues bonds and raises funds on the market to provide temporary financial assistance to countries in financial distress. Bonds are guaranteed by euro area countries according to individual shares and to an **over-collateralization structure** aimed to secure the **AAA rating**

The EFSF contributes to support program to Ireland and Portugal with 17.7 bn and 26 bn

Last October, the euro summit agreed to **enhance the EFSF intervention capacity**: to ring fence those countries that are still solvent, although illiquid

- the effective **lending capacity** was increased to 440bn (from 250bn)
- the range of available instrument was enlarged to include intervention on the debt market, precautionary programs and bank recapitalization
- options under consideration to leverage the resources: **credit enhancement** (partial insurance scheme) and setup of a **Special Purpose Vehicle**

ANSWERS GIVEN: CRISIS RESOLUTION MECHANISMS

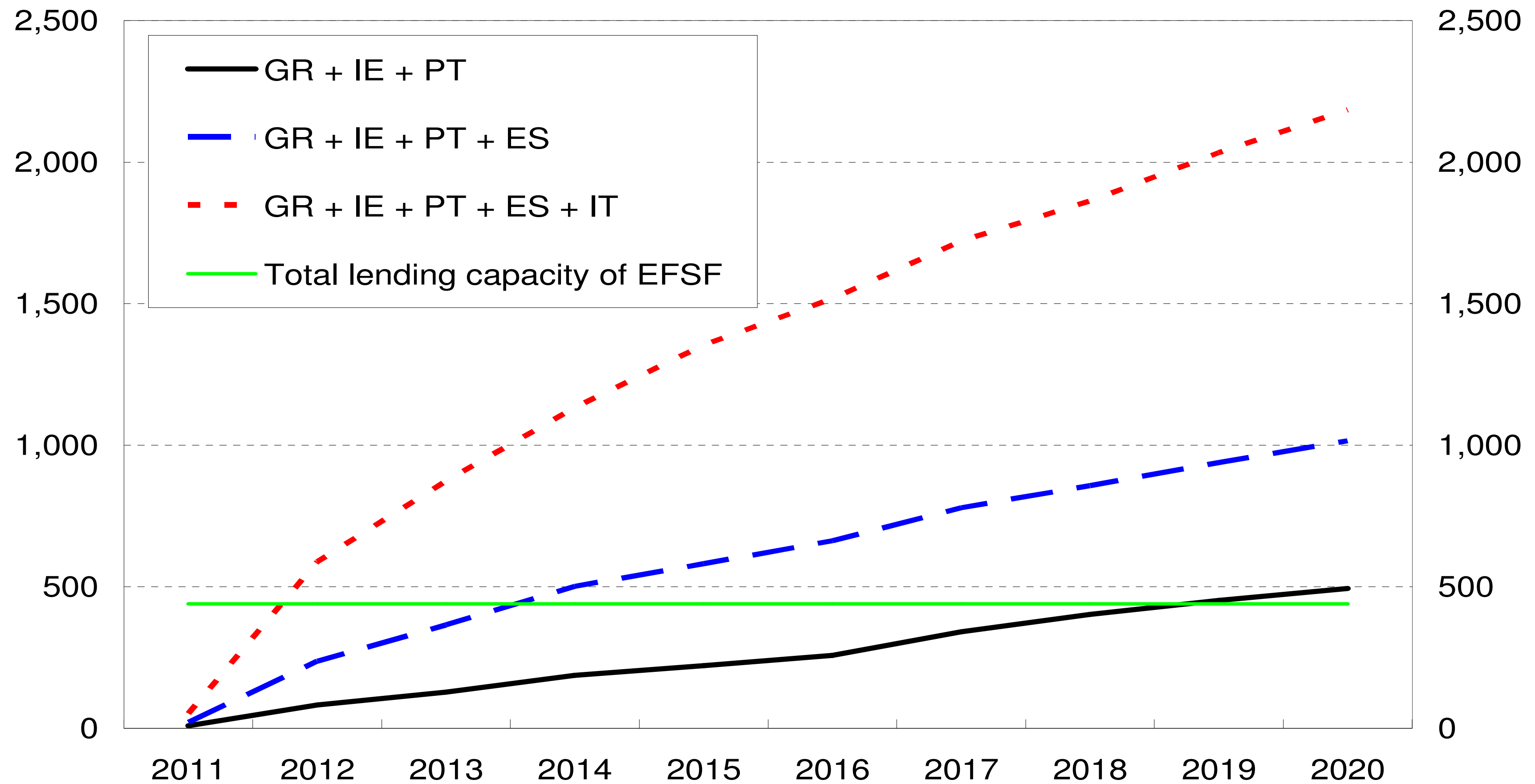
Nevertheless, the residual lending capacity of the EFSF is insufficient to deal with the debt of Italy and Spain. Next Figure

Also the European Stability Mechanism (ESM), designed to substitute the EFSF in 2013 has a limited lending capacity (500bn)

A final decision on how to enhance the financial resources available to the EFSF is expected soon.

ANSWERS GIVEN: CRISIS RESOLUTION MECHANISMS

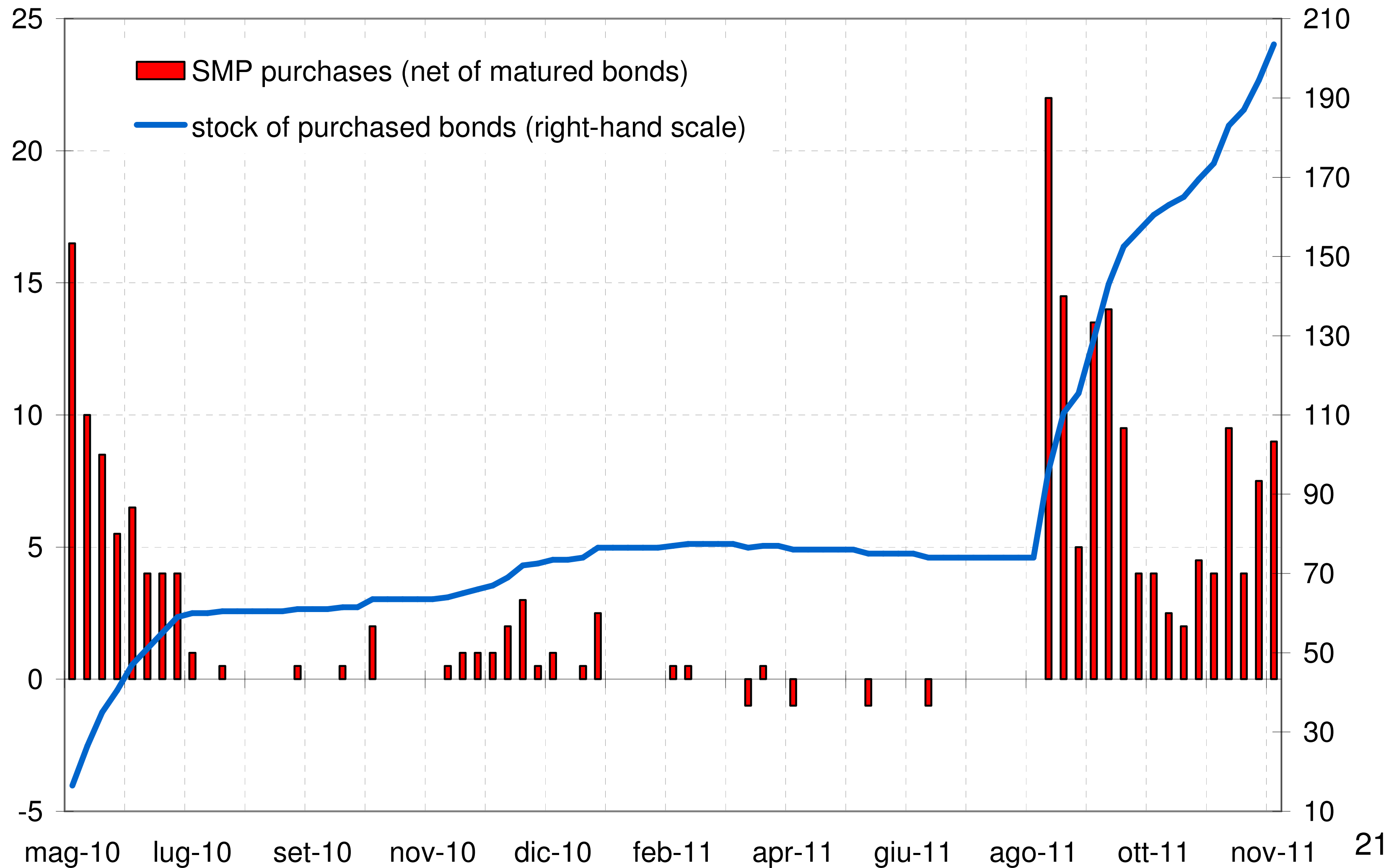
General government securities: cumulative yearly redemption *(bn euro)*



Source: based on Bloomberg data

ANSWERS GIVEN: ECB

Securities Markets Programme of the ECB *(bn euro)*



MARKET DISCIPLINE

Skepticism on the effectiveness of market-based fiscal discipline was present at the foundation of EMU. The Delors Report (1989) pointed out: "*the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive*"

For market discipline to work properly several institutional pre-conditions are needed:
1) information about the actions and budgetary positions of sovereign borrowers should be available to all market participants
2) Bail-out of troubled governments should be credibly ruled out

The decision of the Euro Summit of July 2011 to involve private sector creditors in the Greek public debt restructuring **affected investors' expectations**. In particular, **perception that sovereign debt assets are no longer risk-free spread out**; **tensions also extended to countries whose economic fundamentals were relatively "good"**

MULTIPLE EQUILIBRIA ?

Yield spreads between ten-year government bonds and the German Bund

(basis points)

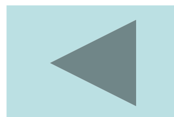
1.700
1.600
1.500
1.400
1.300
1.200
1.100
1.000
900
800
700
600
500
400
300
200
100
0

Greece
Portugal
Ireland
Italy
Spain
France

jan feb mar apr may jun jul aug sep oct nov dec

2008 2009 2010 2011

France Greece Italy Ireland Spain Portugal



ANSWERS GIVEN AT THE NATIONAL LEVEL

Within the euro area, many countries have made good progress in reducing high deficits and specifying medium-term plans and have committed to enhancing fiscal institutions

FISCAL MONITOR (September 2011)

Ambitious fiscal consolidation and structural reforms by national governments in the euro area are required now.

(Jürgen Stark, Member of the Executive Board of the ECB, NY, 2-12-2011)

THE ITALIAN CASE

FISCAL POLICY WAS VERY PRUDENT DURING AND AFTER THE CRISIS

- In 2008, just before the crisis, a strong fiscal consolidation package for the following three years was approved
- Stimulus measures were introduced for 2009 but were almost entirely offset by one-off taxes; there were <u>no stimulus measures for 2010</u>.
- Already in 2010 the gvt deficit contracted by almost 1 percentage point, to 4.6% of GDP (outcome was better than gvt target of 5.0%).
- **Net borrowing in 2011 will fall further to around 3.9% of GDP and a sizeable primary surplus will be achieved (0.9% of GDP).**

THE SUMMER 2011 FISCAL PACKAGES: ALREADY SIGNIFICANT STEPS FORWARD

- Measures approved in July aimed at a balanced budget by 2014.
- Supplementary package approved in early September frontloads the adjustment and aims at balancing the budget already in 2013.
- Overall, the July and August consolidation measures amount to 3.3% of GDP (€54.3 billion) in 2013.

THE ITALIAN CASE : THE LATEST PACKAGE

The new Italian Government, approved, on December 4, an **additional fiscal package** to balance the budget in 2013, even under worsened macroeconomic conditions (GDP falling in 2012 – -0.5% – and remaining stable in 2013) and with unfavourable interest rates on government bonds

The fiscal correction is permanent and sizeable, 20 billion (1.3% of GDP) which add to the measures in the Summer. **Overall, the correction in 2013 amounts to 4.6%, more than 4 times larger than that envisaged in the Italian Stability Program approved in June by the EU Council**.

The bulk of the fiscal correction comes from: 1) an overhaul of the pension system; 2) increases of real estate taxation.

CONCLUSIONS: THE WAY OUT

NATIONAL LEVEL

Fiscal austerity
Improve Institutional framework
Structural reforms

EU LEVEL

Fiscal compact

What I believe our economic and monetary union needs is a new fiscal compact – a fundamental restatement of the fiscal rules together with the mutual fiscal commitments that euro area governments have made. […] a fiscal compact would enshrine the essence of fiscal rules and the government commitments taken so far, and ensure that the latter become fully credible, individually and collectively.

(Mario Draghi, ECB President, Testimony to EU Parliament, 1-12-2011)

European solidarity

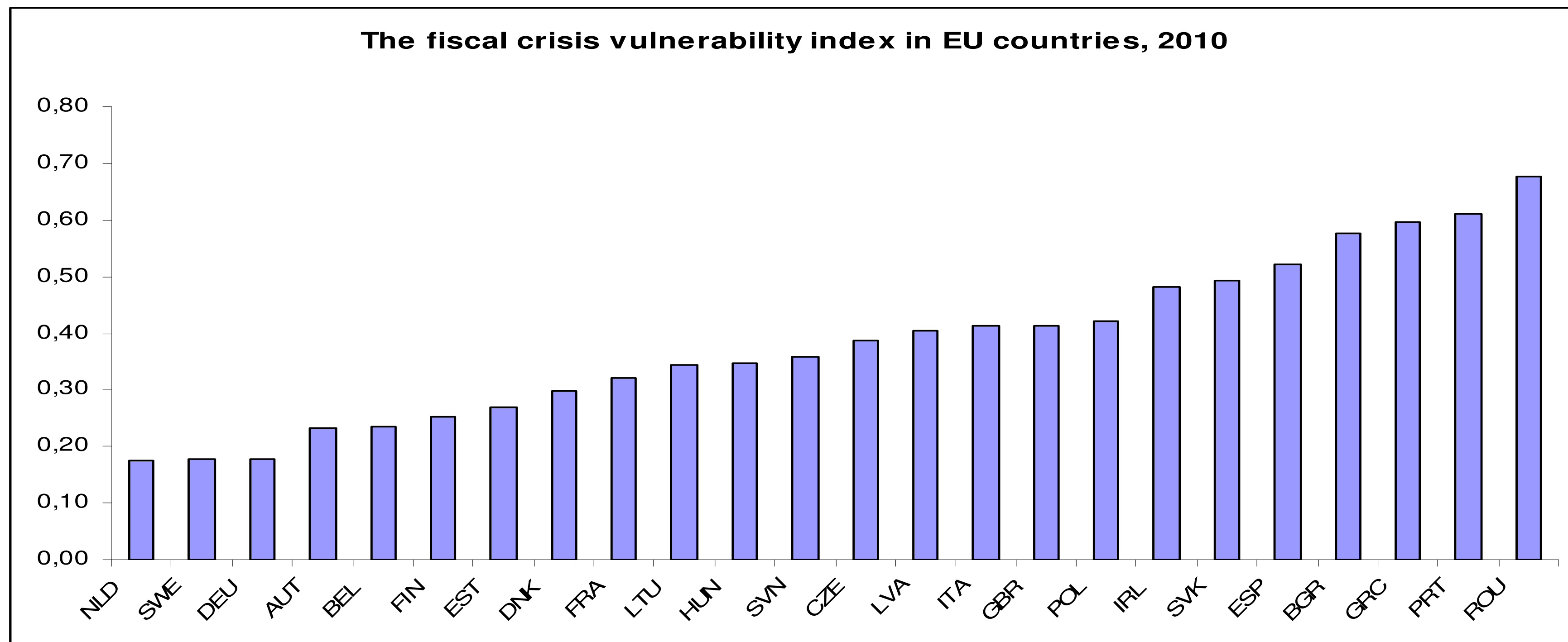
Increase in EFSF/ESM – Eurobonds ?
Stronger ECB SMP – IMF involvement ?

END

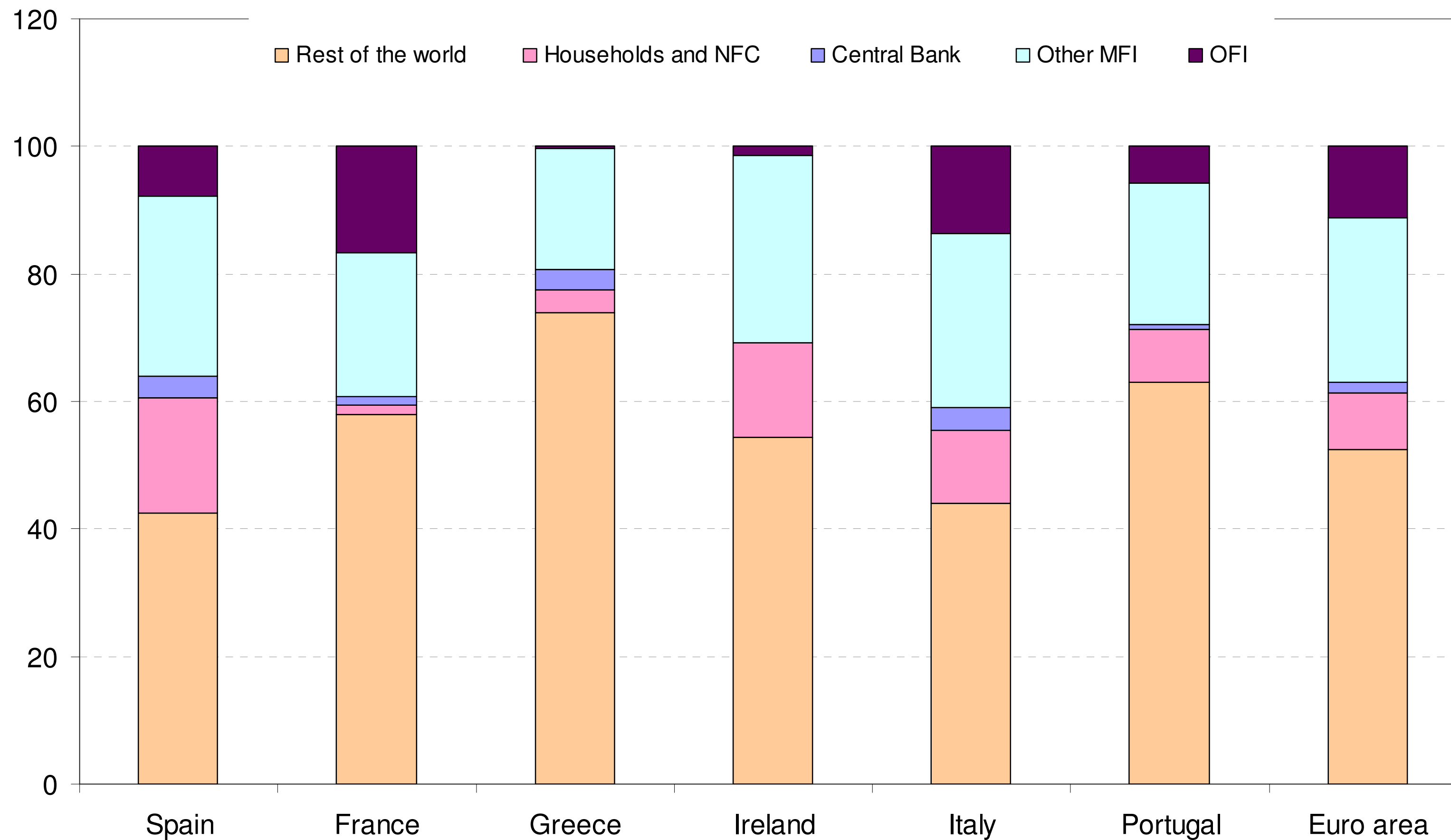
THANK YOU

THE ANALYTICAL WAY FORWARD:
THE NEW VULNERABILITY INDEX

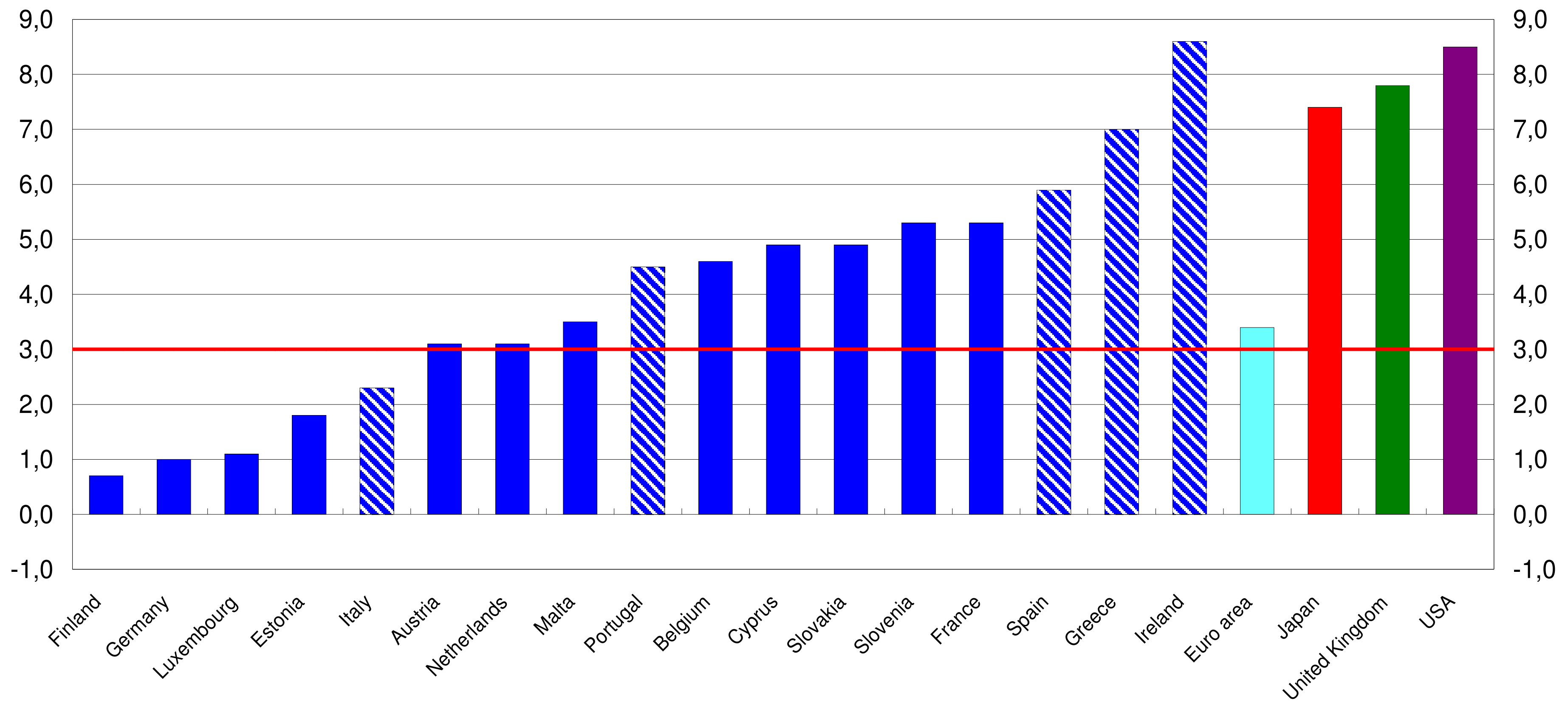
- The European Commission (Public Finances in EMU – 2011) proposes an indicator of vulnerability to a fiscal crisis taking into account **purely fiscal but also macroeconomic, financial and competitiveness variables.**
- For each variable the approach is to find an optimal threshold that maximizes the ability to predict a fiscal crisis, as defined in Baldacci et al. (2011).
- Financial-competitiveness variables seem to be better "leading indicators" for fiscal crises than fiscal variables are.



DEBT SUSTAINABILITY AND MULTIPLE EQUILIBRIA SCENARIO



Net borrowing in 2012 (% GDP)



European Commission Autumn Forecast

General government consolidated gross debt in 2012 (% GDP)

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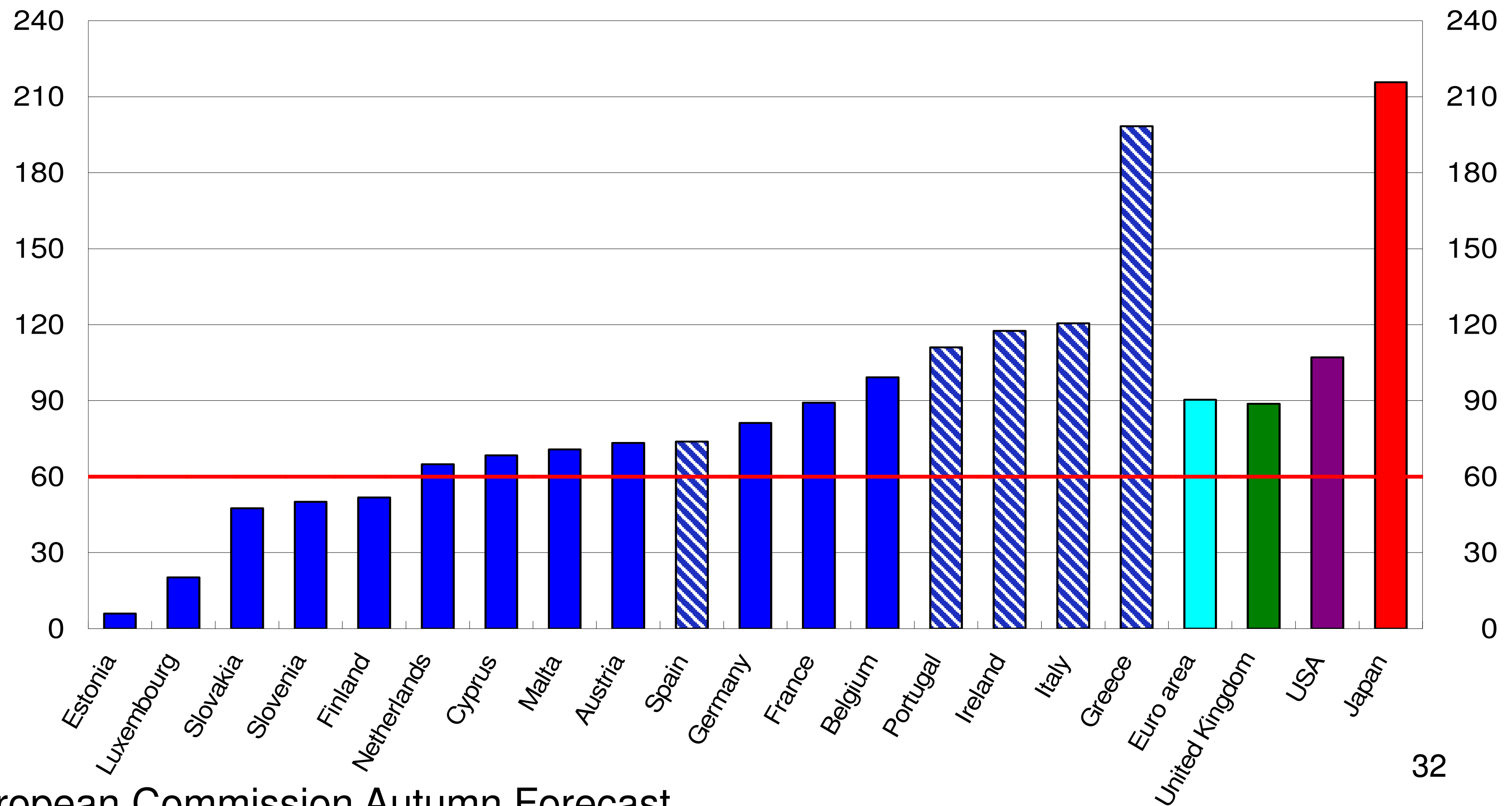

European Commission Autumn Forecast