COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

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Discussion of "Bond Yield Spreads and Numerical Fiscal Rules at the National Level" by Anna Iara and Guntram B. Wolff, and of "Crisis Prevention, Crisis Management and Sovereign Debt Restructuring" by Werner Ebert and Christian Kastrop

The economic constitution of the euro area assumes that macroeconomic stability is a necessary condition for sustainable growth and employment creation. For most advanced economies public finances are threatened by long run developments, associated with the demographic transition and the prospect of population declining. The global crisis and the policy response it entailed led to an immediate accumulation of public debt to unprecedented levels in peace time. In this context fundamental fault lines in the Maastricht architecture were revealed. Specifically, Maastricht rested on three key features: first, fiscal sovereignty; second, the impossibility of sovereign default; third, the absence of a crisis management mechanism. Unfortunately, once the second element is questioned the full triangle falls apart: national sovereignty, no bail out and no default cannot simultaneously hold up under stress.

At the time of the Public Finance Workshop (31 March-2 April, 2011) sovereign risk was a salient feature of euro area bond markets, dominating everything else in the cases of Greece, Ireland and Portugal. The rules and procedures for budgetary discipline in the euro area, agreed at and after Maastricht, aimed at supplementing market discipline. The Delors Report famously stated that market discipline could not be fully relied upon because it was likely to be too slow and weak (in tranquil times) and too sudden and disruptive (under stress). A chart displaying bond yield differentials, for euro area sovereigns, during the last decade one illustrates the empirical phenomenon that the rules and procedures in place were designed to avoid. The failure of governance in the euro area is, therefore, undeniable.

Relevant policy questions include:

- Will the euro area and its Member States successfully overcome the crisis?
- Will rules and procedures in the euro area deliver sound fiscal policies in all Member States?
- Will it prove possible to reconcile financial integration and financial stability?

These questions imply looking at:

- National frameworks for budgetary discipline and financial stability;
- European rules, procedures and organizations involved in crisis prevention; and
- International and inter-governmental mechanisms for crisis management and resolution.

The presentations by Anna Iara and Christian Kastrop address fundamental aspects of these issues.

The paper by Iara and Wolff brings new evidence to bear on the European Commission's traditional view that numerical fiscal rules are instrumental for achieving sound budgetary outturns (see, for example, European Commission, 2006). The new twist, explored by Iara and Wolff, is to look at the question of how have numerical fiscal rules influenced the evolution of sovereign debt yields? Given the central role of bond yields and bond yield differentials in the context of the

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sovereign debt crisis in the euro area, the policy relevance of the question does not require further elaboration.

The authors rely on a wonderful database on national fiscal governance compiled and made available by DG-ECFIN (European Commission).[1]

Iara and Wolff conclude that national numerical rules matter and that they have a significant quantitative impact. Specifically they find that the effect can be up to 100 basis points on sovereign yield differentials, in periods of elevated risk and risk aversion. As already said, the research is perfectly timed and it is highly relevant from a policy viewpoint. The results are totally in line with my prior opinions. In other words, the authors' findings are in line with my prejudices.

The interpretation of the empirical results is, however, difficult. The difficulty comes from joint endogeneity. To be concrete, consider the following two questions:

- Do markets assess the authorities' commitment to budgetary solvency on the basis of numerical fiscal rules?
- Does market credibility reflect some other institutional and political fundamentals that correlate with the existence of numerical fiscal rules?

The point is that if a country is serious about budgetary discipline, and, in particular, about budgetary adjustment and consolidation, it will set itself numerical budgetary targets. However, in the absence of such serious commitment, the setting of targets *per se* is unlikely to help very much. The identification of the effect of numerical fiscal rules requires the control of all other possible influences. The attempt to control for these effects requires that the possibility of endogeneity be considered when choosing the estimation method. Equally important, the results will depend on the information set used (as relevant control variables). It is very hard to draw a complete list. It would suggest that a natural starting point would be a list of determinants of systemic risk.

In the end, I think that the authors already contribute significantly to a central and timely policy debate. I am looking forward to further progress in their important research.

The focus of Werner Ebert and Christian Kastrop is even broader. Their presentation provides a critical overview of the comprehensive package of legislative initiatives, laying the foundations for the new architecture for fiscal and financial stability in the euro area. The relevance of their question cannot be overstated. The task of building new foundations for lasting stability while the crisis is ongoing makes Otto Neurath's image apt (paraphrasing): it is like rebuilding a boat, on the open sea, while floating on it. Ebert and Kastrop argue that the proposals on the table constitute significant improvements on the current framework. I agree. They also ask whether the next version of the Stability and Growth Pact (they label it SGP 3.0), as complemented by the European Stability Mechanism and Financial Market regulation and supervision is up to the task of preventing and managing systemic financial risk in the euro area. They also comment on broader issues at European and global level but I will not consider these aspects in my comments.

My own thinking on these issues has been influenced by Jean Tirole (2010). One of his punch lines is: "Crisis resolution is never pretty. The choice is between the bad and the ugly." Avoiding such unpalatable trade-offs requires careful institutional design *ex ante.* Unfortunately it is the case that political rewards associated with careful long term institutional design are meagre. If this is true it follows that some of the main difficulties are political. It may, however, be the case that in order to make it possible to sustain official creditors' involvement in current crisis management, a fundamental redesign of the overall framework is necessary.

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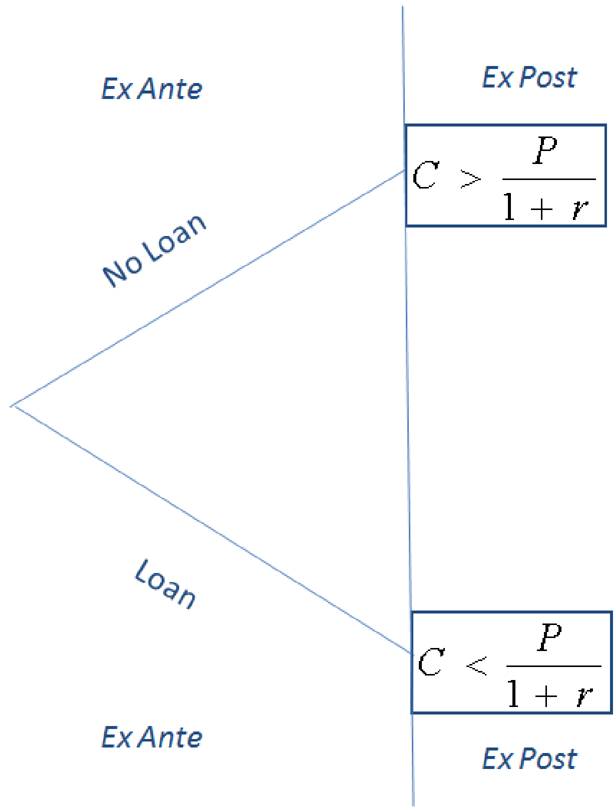
[1] The database is available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

Figure 1

Sovereign Debt Contracts



Following Jean Tirole, it is natural to start by looking at a loan contract. The enforcement of a standard loan contract between private entities is relatively straightforward. Often private lending relations involve the pledging of collateral. If the borrower defaults it is then relatively straightforward for the lender to obtain control over the agreed collateral. Enforcement, if necessary, is ensured through the national court system. Irrespective the pledging of collateral defaults in advanced economies are regulated by bankruptcy law. In some countries the specificities of these cases are recognized as justifying the organization of special bankruptcy courts.

Interestingly this leads us to a major difficulty in the area of sovereign debt. Sovereignty gives to each country supreme legal authority within its borders. Sovereignty implies that foreign governments cannot impose the fulfillment of contractual obligations, within the boundaries of a state, without the collaboration of the relevant national authorities. In particular, sovereignty denies creditors the right to exercise their rights, inside national borders, by, for example, seizing assets or interfering with revenue flows. This leads to two related questions:

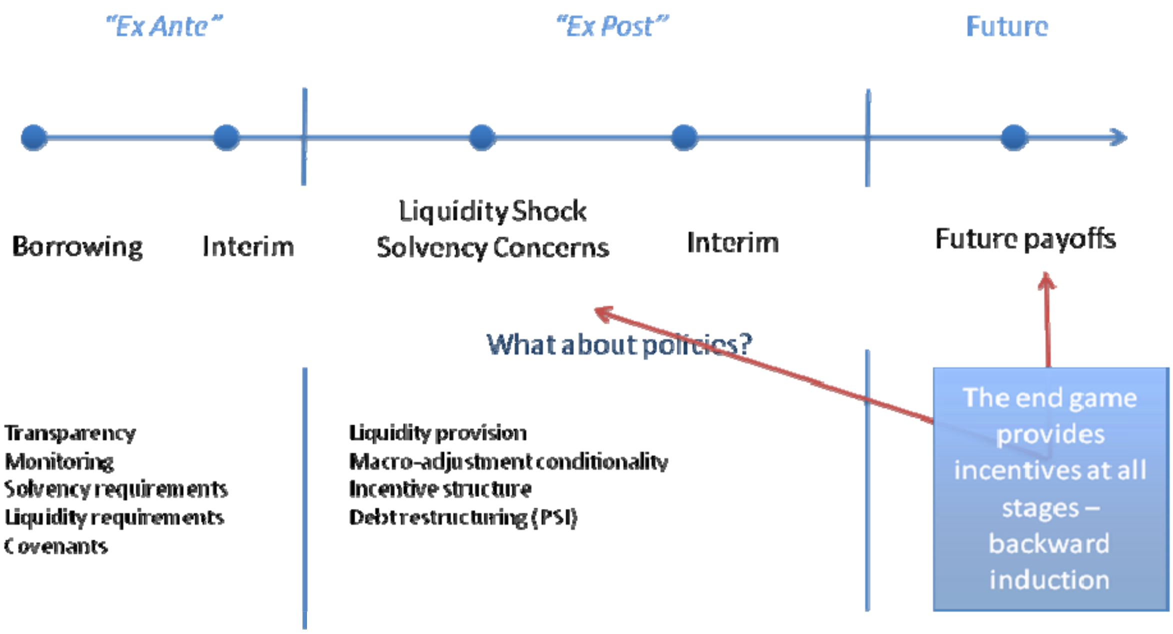
- How do lenders induce the sovereign ever to repay?
- How is it possible that sovereign borrowers can tap substantial amounts of funds?

Let us consider a very simple framework, used by Schulz and Weingast (2003) – see Figure 1. Assume that in case of no-repayment the sovereign incurs a penalty, P (we disregard for the time being what such a penalty may be). If we further assume a one-shot credit relation, it must be the case that a rational sovereign will repay if the penalty exceeds the principal plus interest [$C(1+r)$]. Otherwise the sovereign will default.

Our question above suggests that it is up to the creditors to devise a penalty that will induce the sovereign to repay. However, assuming that there is competition in the credit market and that alternative opportunities for investment exist, the opposite is true. The problem of devising an appropriate penalty is the sovereign's. In its absence the sovereign does not have a commitment mechanism and, therefore, no credit will be granted. The stronger the penalty, the more effective the commitment mechanism, the greater the sovereign's borrowing limit. In the extreme case where the penalty is zero, no rational sovereign will ever repay a loan, and no rational lender will ever

Figure 2

Debt Adjustment and Private Sector Involvement



provide one. This explains the fundamental insight emphasized by Jean Tirole: institutions are about making credible to investors that they will recover their investment (in addition to a competitive return). In these conditions it is borrowers who benefit from investors' protection. Investor protection allows borrowers to access financing in competitive terms. Otherwise financing will not be available.

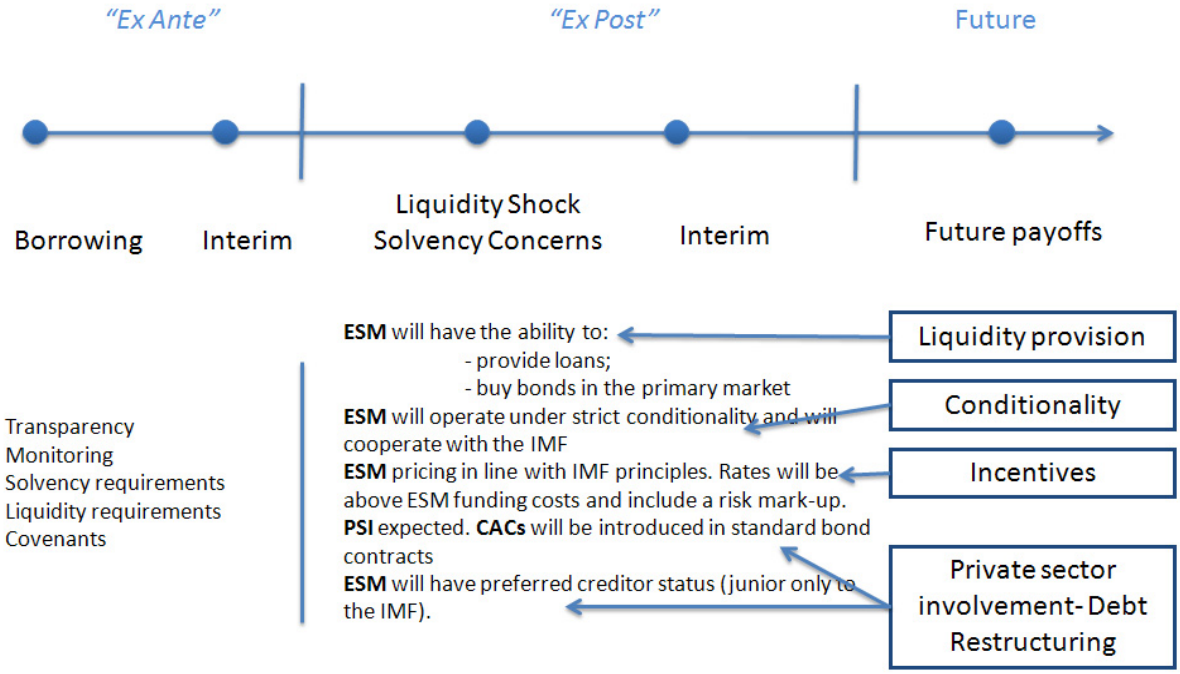
Figure 1 illustrates a number of important points. Let us focus on only two. First, in order to be able to understand a credit relation it is necessary to think about the end game and to work out the implications for credit transactions by backward induction. Second, the architecture of Maastricht, assuming national competence for budgetary policy, no crisis management mechanism and the impossibility of sovereign default is inconsistent. The potential for inconsistency to create havoc is unleashed as soon as the risk of sovereign default becomes a salient driver of trends in bond markets. Even a superficial and sloppy examination of developments in bond markets, since the beginning of 2010 (and even earlier), leads to the conclusion that this is the case.

Figures 2 and 3 are inspired by a diagram from Tirole (2010).[2] My reading of Jean Tirole suggests that, despite important differences, there are a number of important common features and policy principles that apply similarly in the case the borrower is a country or a systemically important bank. The sequencing in Figure 2 is straightforward. *Ex ante* borrowing occurs. In the contract stage it is possible to agree on debt covenants, including liquidity and solvency requirements and also to specify transparency requirements, in order to facilitate monitoring. After the *ex ante* stage a disturbance may occur that signals potential liquidity or solvency problems. For substantial disturbances liquidity and solvency become dominant concerns triggering a crisis. Under these conditions it is necessary to enter crisis management and resolution mode, including macroeconomic adjustment, liquidity provision, financial support, debt restructuring and private

[2] Many versions of the diagram are included in Tirole (2006).

Figure 3

European Stability Mechanism



sector involvement. As in Figure 1, only the specification of the end game allows one to work out whether a credit relation is viable (and on what conditions).

Figure 3 makes it clear that the European Stability Mechanism addresses the standard questions raised in mechanism design. First, the ESM is able to deal with liquidity shortages. The ESM has the ability to provide loans and to buy bonds in the primary market. Second, the ESM will operate under strict conditionality and will cooperate with the IMF. Therefore the requirements for macroeconomic adjustment will be in line with standard IMF practices. The disbursement of financial assistance in tranches provides incentives for the country to comply with conditionality. Third, the pricing of loans by the ESM will also follow standard IMF practices. Rates will be above the ESM funding costs and will include a mark-up. The second and third elements aim at controlling sovereign moral hazard. Fourth, ESM financing decisions will be based on a judgment on whether the sovereign is facing a problem of liquidity or a problem of solvency. If, according to the best judgment possible, based on preparatory work by the European Commission (in a procedure involving the European Central Bank) and the IMF, the problem is of liquidity, the government of the country concerned will be asked to endeavor to obtain commitments by private creditors that they will not diminish financing amounts outstanding. In contrast, in case of solvency problems, orderly private sector involvement is called for. Losses to private creditors provide incentives for proper monitoring on the lenders' part. Fifth, the ESM will enjoy preferred creditor status (junior only to the IMF). Preferred creditor status on the past of official creditors matches private sector involvement. In the Conclusions of the March European Council, private sector involvement is to be considered on a case-by-case basis. Such an approach may be called a contractual approach.

I think it is fair to say that the European political system delivered answers to key policy questions. It did address head-on the inconsistent trilogy underlying the Maastricht architecture.

However the question: “Are the answers any good?” remains relevant. Ebert and Kastrop argue that an overall systemic approach would be called for. In such an approach, the excessive deficit procedure, the excessive imbalances procedure, systemic risk, regulation and supervision of financial markets and organizations and crisis management would be much more than mere complements – they would be designed as integral parts of the same framework. Clearly, in this context, the interdependence between the domestic banking system and the general government finances is a major source of macro-systemic risk. The authors’ point is very well taken, though, I think, the presentation is lacking in details.

There are two points that I think can be elaborated further. Both explore parallels and differences between private and sovereign bankruptcy. In the early 2000s, the IMF (IMF, 2002 and 2003 and Krueger, 2002) proposed the creation of an international bankruptcy procedure for sovereigns. The starting point is to start from laws, regulations and practices for corporate reorganization. The reason is that liquidation of a sovereign state cannot be foreseen from a legal point of view. Sovereign default is fundamentally different from corporate default, on three accounts:

First, there is no legal code (in domestic law) foreseeing liquidation of sovereigns debtors. Corporate recovery proceedings take place under the shadow of possible liquidation. There is no international recognized process for handling sovereign defaults or restructuring operations.

Second, the concept of sovereign immunity protects the sovereign’s assets even if held outside the territory.

Third, the idea of reorganization proceedings is to maximize the value of the firm as a going concern. That may entail transfer of control to creditors through debt-equity swaps. No such a mechanism is available for sovereigns.

Nevertheless it may be useful to look carefully at a well ordered corporate reorganization procedure. It involves mainly four features:

- First, a stay on creditor enforcement pending the negotiations – to preserve the value of the firm as a going concern and to solve creditors collective action problems.
- Second, provisions protecting creditors during the stay.
- Third, mechanisms facilitating new financing during the proceedings – seniority clauses for new financing.
- Fourth, Provisions binding all creditors to an agreement acceptable to some well-defined majority.

The two points I want to stress are as follows. First, the combination of an announcement that no debt issued before 2013 would be restructured and that private sector involvement would be sought after that date violates principle 3 for a well-ordered scheme and makes market access difficult for countries under an adjustment program (or countries that may fall under such program). Clearly access to fresh market financing is difficult to make compatible with the possibility of sovereign default, uncertainty about the implications of such an event, sizable official support and seniority of official financing. It is difficult to imagine a rational investor engaging in such a game. Second, there are reasons to believe that given potential systemic implications from sovereign restructuring and other complications it is highly uncertain that a contractual case-by-case approach will be enough to anchor expectations about the end game. Neurath’s boat applies.

As I have argued in the discussion, open questions going forward include at least the following:

- Will the emerging permanent architecture prove effective and enduring? Will it make sovereign debt crisis less likely? Will it help contain systemic and contagion effects in the event of a crisis?
- Will it facilitate adjustment and contain financial stability spillovers in the context of the current crisis?
- Will the process lead to sound, prudent and robust national budgetary frameworks in all Member States?
- Will politics in Europe deliver this time?

Positive answers should underpin the success of the euro area going forward. It was very fortunate for me to be asked to comment on two papers that motivate such a comprehensive reflection on the governance of the euro area for macroeconomic and financial stability.

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