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Comment on "Sovereign Bankruptcy in the EU: A Comparative Perspective" by Leszek Balcerowicz, Lectio Marco Minghetti 2010, Istituto Bruno Leoni, Rome, 26 October 2010

More than three years after the emergence of the financial excesses and regulatory failures that triggered a global economic crisis second only to that of the 1930s, its consequences are still to be fully understood and, especially, adequately addressed. In the aftermath of the Great Recession of 2008-09, we are left with a series of risks linked to the possible re-emergence of global imbalances and associated turmoil in currency markets and to the huge accumulation of public debt in advanced economies, which could lead to higher borrowing costs and further financial turbulence if markets started to worry about its sustainability. The two risks are interrelated and are the subject of discussions within the G20 and in other venues. Serious sovereign debt distress has indeed materialized this year in a number of countries, in particular in the euro area, and issues such as debt resolution mechanisms and the design of fiscal rules have again come to the forefront of the policy debate in the European Union (EU). They are the subject of this most interesting lecture by Leszek Balcerowicz and I will deal with them sequentially.

Sovereign debt distress resolution mechanisms

Rather than focusing on the standard distinction between illiquidity and insolvency that may characterize situations of debt distress, Balcerowicz emphasizes that a sovereign default is most likely the result of unwillingness rather than inability to pay back a debt accumulated over time. This is a very reasonable starting point, as it is most likely that when structural reforms or macroeconomic adjustments that could help a country to regain solvency are not adopted, this is not for lack of possibilities but because they are deemed undesirable – the sovereign debtor prefers not to take on all the burden of the required adjustment – or socially and politically unfeasible – the government may not be able to pass and enforce the consolidation package. Indeed, governments are different from firms. While the latter are forced to go bankrupt when they do not have enough resources to repay their creditors, governments may choose to default on their obligations even though, in principle, they could always find ways to honour their debt by cutting expenditures and/or increasing revenues.

Concerning the desirability of a default, however, as the IMF has recently pointed out[1], a default is not an easy substitute for a painful fiscal adjustment. In fact, when the starting position of the defaulting country is a primary fiscal deficit, a marked move into a primary surplus is also required, as the country usually has no longer access to borrowing in the aftermath of a default. This would indeed be the case for many advanced economies today, for which the interest bill is not the main component of the deficit.

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[1] Cottarelli, Forni, Gottschalk and Mauro (2010).

I agree with Balcerowicz that the standard approach, treating the debt-distressed sovereign as a benevolent social planner maximizing social welfare in an infinite time horizon, is not appropriate. Different strategies to cope with a high-debt situation entail different redistributive consequences and social groups have often conflicting economic interests with respect to the policy to pursue in the midst of a debt crisis. The choice made by governments to cope with high public debts may therefore be better explained from a political economy perspective: the specific interests and relative political strength of different constituencies may definitely matter in such a choice.

This approach can also help to explain the historically observed phenomenon that some countries are more likely to default than others;[2] to cite just one example, Argentina has defaulted three times since 1980. Moreover, most debt repudiation episodes in these default-prone countries happened at what we would today consider relatively low levels of debt. At the end of 2001, for instance, when Argentina defaulted on the larger part of its public debt, the debt-to-GDP ratio was slightly above 50 per cent (though already 15 percentage points higher than three years earlier and 90 percentage points below its nominal value one year later, after the 1-to-1 peso-dollar parity had been abandoned). By contrast, there are countries and governments that can sustain much higher borrowing levels. A striking case is Japan, whose public debt recently reached 220 per cent of GDP without giving rise to significant market tensions.

Several authors have argued that the degree of debt intolerance ultimately depends on the quality of a country's institutions. In particular, sovereign default is often the outcome of a political struggle among different groups of citizens and is more likely to happen if domestic debt-holders are politically weak and the political price of the financial turmoil typically triggered by a sovereign bankruptcy is low. These conditions are in turn more likely to be present if a country lacks a politically strong middle class and/or a sufficiently independent central bank[3]. As Balcerowicz remarks, in a world of financial liberalization the traditional distinction between domestic and foreign debt may not be that useful in explaining governments' willingness to pay. While in the cases of Russia (1998) and Argentina (2001) the distribution of the public debt between resident and non-resident holders certainly did matter, with governments treating domestic creditors better than foreign ones, in the case of Turkey (also in 2001) default was not contemplated and the government took measures that helped to service the debt owned by both domestic and foreign creditors.

It is worth noting that the share of public debt held by non residents has risen significantly in all European countries, owing to the integration of financial markets. However, not only the composition of debt holders but also other characteristics of the public debt matter in such circumstances. For example, a long enough maturity of government debt can make default avoidable, even for a country that records sizeable increases in yield spreads. The average cost of debt would react slowly, buying the country considerable time to convince the market of its solvency. It can be debated whether the existence of alternative sovereign debt resolution mechanisms can create different *ex ante* incentives, influencing the behaviour of sovereign debtors and their creditors. The lecture delves into the pros and cons of the Sovereign Debt Restructuring Mechanism (SDRM), a debt resolution mechanism, yet to be implemented, proposed in 2001 by Anne Krueger, then IMF First Deputy Managing Director.

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[2] Cf. Reinhart, Rogoff and Savastano (2003).

[3] Cf. Giordano and Tommasino (2009).

Balcerowicz concludes that the SDRM is functionally equivalent to the already existing debt resolution mechanisms, and says that more faith should be placed in the working of "pure market solutions". However, he also seems to accept the notion that, as the SDRM is a more debtor-friendly mechanism, it could induce more fiscal discipline, strengthening the financial markets early warning function. In my opinion, this is not a secondary aspect. The key to an efficient approach to preventing sovereign distress lies in strengthening market pressure while also making it operate more gradually than is usually the case. An example is the Greek crisis. The spread between 10-year Greek and German bonds was less than 30 basis points in 2007. It widened to about 150 at the end of 2008 in the aftermath of the Lehman Brothers collapse and then fluctuated between 100 and 250 basis points until the beginning of this year. After that it skyrocketed, surpassing 900 basis points in the summer, and only in recent weeks has it fallen back somewhat to below 700.

Of course, any institutional reform that forces governments to become more sensitive to the warning signals coming from financial markets is welcome. With the Stability and Growth Pact (SGP) the EU decided to use fiscal rules rather than market constraints, which were considered ineffective and slow in imposing fiscal discipline. As early as 1989, the Delors Committee had remarked that: "The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive"[4]. A solid fiscal framework can improve budgetary coordination over time by removing the built-in bias towards fiscal profligacy that is often attributed to democratically elected governments. A medium-term fiscal framework is particularly important, especially in the current situation, which requires credible plans to anchor expectations and, at the same time, a degree of flexibility in implementation so as not to hamper economic growth. However, it does not follow from this that market forces necessarily have to work only *ex post* and continue to be "too slow and weak or too sudden and disruptive". We must strengthen "gradual" market pressure. For that, I believe having pre-defined procedures for debt-restructuring and a well-designed crisis management framework would help greatly. Defaults are certainly "unnecessary, undesirable, and unlikely", as Cottarelli et al. (2010) assert. But we should not only be ready in case they take place but also have institutions capable of conveying to the market the message that they are in fact possible.

The sovereign debt crisis and the institutional setup in the EU

I agree with the idea that what we ultimately need is a "strong representation of fiscally conservative voters". But how can we implement this? In principle, by building a wide consensus on the advantages of fiscal discipline we may actually induce voters to punish policy-makers who do not deliver it. Asking voters to agree on fiscal consolidation packages without convincing them of their advantages is not straightforward. But well-designed, stable and easy to apply fiscal rules can contribute to the emergence of a public consensus in favour of policies aimed at fiscal sustainability.

In the second part of his lecture Leszek Balcerowicz focuses on the problem of sovereign debt in the EU, analyzing three main aspects: *(i)* the management of the Greek crisis; *(ii)* the development of a debt resolution mechanism in Europe on the heels of the Greek experience; and *(iii)* longer term solutions for the stability of the euro area.

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[4] Committee for the Study of Economic and Monetary Union (1989), p. 20.

According to Balcerowicz, a double standard emerged between euro- and non-euro countries in the EU. The vulnerable fiscal position of some euro-area countries led to the fear of contagion. After a lengthy debate and with a significant delay, the possibility of an IMF intervention was finally accepted. For non-euro countries, where the risk of contagion was considered modest, the application for IMF conditional loans was not controversial. In the case of euro-area countries, however, such as Greece, a complete set of intervention options was never put on the table; some options were not considered at all, basically due to motives of prestige.

With reference to the second point, Balcerowicz charges that the European Financial Stabilisation Mechanism (EFSM) is inconsistent with the letter of the Article 122.2 of the Treaty. He also criticizes the ECB's Securities Market Programme as a possible threat to its reputation. Finally, turning to the analysis of long-term solutions, he advocates a proper institutional setting able to avoid pro-cyclical policies. Structural reforms should be implemented to spur long-run growth and to promote the adjustment of the economy to shocks.

It is quite difficult to assess a single article of the Treaty out of context. The consistency of the EFSM with the letter of the Article 122.2 could be debated, but it is evident that the EFSM complies with the spirit of the Treaty, given the importance of the proper functioning of the EU and its very existence. Earlier this year, it was indeed conceivable that a debt crisis in a euro-area country could trigger a wider crisis involving other countries.

Should a balance-of-payments crisis hit a member state, Article 143 of the Treaty governs mutual assistance. Hungary received support on this basis. A similar mechanism was missing in the context of economic and financial crises with impact on sovereign debt. The European Financial Stability Facility (EFSF), established in June by the Ecofin, fills the gap. The crisis has shown that the costs for the economy can mount quickly if crisis management is slow and if it is conditioned by political pressure in both the countries receiving and those providing financial assistance. It is now clearer than before that well-defined procedures need to be established to provide temporary financial assistance under clear and enforceable conditionality. The EFSF is an important step in this direction.

In order to guarantee an incentive-compatible scheme, the EFSF has been associated with efforts in strengthening policy coordination in the EU. The crisis has confirmed that the reasons underlying the introduction of EMU fiscal rules (externalities of deficits and debts, pressure for bail out, moral hazard in fiscal policy) are still very relevant, as national rules and financial market discipline do not necessarily deliver sound policies. EU fiscal rules are warranted and should be strengthened. Under the European Commission proposal put forward at the end of September, compliance with rules and principles of the SGP is going to be reinforced by speeding up the Excessive Deficit Procedure and giving more prominence to public debt and sustainability criteria. The broader surveillance of euro-area macroeconomic and competitiveness developments makes it possible to focus on structural issues. The involvement of the EU in developing the *ex ante* dimension of budgetary and economic surveillance is based on the assumption that prevention can be more effective than correction. Sanctions can play a role in dampening the relative convenience of profligate fiscal policies, but a system of early peer-review of national budgets could detect inconsistencies and emerging imbalances at an early stage.

The Van Rompuy task force too will soon publish detailed proposals. It is important that the European Council rapidly evaluate these proposals, jointly with those of the Commission, and come up with an effective decision that tackles the two main weak points of the SGP (in both the 1997 version and the 2005 revision): *(i)* the absence of incentives and sanctions for fiscal behaviour in good times, and *(ii)* the lack of an independent enforcer of EU rules. Sanctions have been highly uncertain, as EU Council members were supposed to fine each other via lengthy procedures involving discretionary steps that would lead to theoretically large, but actually unlikely, pecuniary sanctions. Reforms such as the interest bearing deposits and the European semester aim at tackling the first problem. A greater automaticity in procedures, the reduction of EU funds and, possibly, the loss of voting rights would help in tackling the second problem. National fiscal rules and procedures can also help to pursue fiscal consolidation and anchor fiscal expectations. The 2009 reform of the German fiscal framework sets an important benchmark.[5] Other countries may decide to assign a greater role to expenditure rules and to independent fiscal authorities.

With respect to the proposals advanced to make the debt criterion operational, the Commission's suggestion of allowing excessive deficit procedures for insufficient debt reduction (vis-à-vis an annual 1/20 reduction of the excess over the 60 per cent standard for the debt-to-GDP ratio over a three-year period) has been praised for its automaticity as well as its simplicity. It has been argued that "the practical translation" of the debt principle is "elegant, but short-termist", even if this "way of turning around the 60% nonsense is undoubtedly clever".[6] There is no question, however, that a consistent and progressive reduction of the current high debt levels over the cycle is absolutely necessary; they are a major constraint on our countries' adjustment possibilities, especially in the event of shocks that could have irreversible consequences (due either to the unwillingness to pay or to the socio-political unfeasibility discussed by Balcerowicz). In this perspective, it seems beside the point at this stage (and impossible given the letter of Treaty) to question the reference standard, as well as the speed of convergence, even if we may readily acknowledge that "business cycles usually extend over more than three years".[7]

The debate on how to cope with the accumulation of public debt following the crisis has led – *inter alia* – to some proposals for European countries to pool their debt at least up to a certain level (60 per cent of GDP)[8] or to pool in a fund operating in the market (and possibly financed with a levy on financial transactions) the share of their debt directly tied to rescuing the financial system (a proposal not limited, in this case, to the EU).[9] Both types of proposal are interesting and may improve market liquidity. The first would be especially directed at reducing the burden of debt, the second at offsetting the negative consequences of debt accumulation related to the financial crisis. They leave, however, significant open questions. To mention only a couple: *(i)* it may be hard to reach a consensus on the definition of the share of debt that has to be pooled; *(ii)* countries having debt substantially in excess of such a share may face a bond market liquidity problem. In addition, these proposals pose problems in terms of incentives to participate for countries with lower debt and higher credibility (typically Germany) and with less debt directly tied to rescuing the financial system (typically Italy). More generally, these schemes imply some cross-subsidization which is hard to price, even though in the case of the establishment of a fund, profits may be used to progressively compensate different country contributions.

But we should be aware that weak fiscal positions are not the only source of the tensions on sovereign debt. In 2007 Ireland and Spain recorded fiscal surpluses (respectively 0.3 and 1.9 per

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[5] See Franco and Zotteri (2010).

[6] Wyplosz (2010).

[7] Ibidem.

[8] Cf. Delpla and Von Weizsacker (2010).

[9] V. Visco (2010), and, for a similar proposal that contemplates the transfer of such debt in excess to an international institution such as the IMF, Savona (2010).

cent of GDP) and had relatively low public debt-to-GDP ratios (25 and 36 per cent, respectively). This suggests, as Balcerowicz also acknowledges, that standard fiscal indicators are not sufficient. Moreover, a tighter fiscal policy can sometimes help, but it is not a panacea for macro imbalances. The European Commission now suggests introducing a new Excessive Imbalances Procedure. It will comprise the regular assessment of the risks of imbalances based on a scoreboard composed of several economic indicators. Indicators of both the external position of the economy (e.g. current accounts, external debt, real effective exchange rates) and of the internal situation (e.g. private, as well as public, sector debt) should be considered. The proposal, though important, faces three difficulties: first, detecting macroeconomic imbalances may not be simple; second, identifying appropriate policies to address structural problems is not straightforward; third, putting pressure on a country from Brussels can be politically difficult when all seems to be going well. This is an area in which national independent authorities could have a role.

A very important issue concerns the lessons we have learnt from the crisis for the design and the conduct of our monetary policy, as well as for its interactions with macro-prudential policies. If anything, the crisis has confirmed that we should firmly stick to our objective to deliver price stability in the medium term. Indeed, the credibility of the Eurosystem in pursuing this objective was crucial in allowing us to adopt exceptional measures without compromising the anchoring of inflation expectations. The crisis has also shown how important it is to interpret credit and money developments properly and take them into account in our decisions, in particular by "leaning against the wind" in case of credit booms and asset price imbalances. This is embodied in the Eurosystem setup, insofar as the careful monitoring of monetary and credit aggregates helps to identify risks both to financial and price stability. A crucial issue is how to detect the accumulation of systemic risk in time. I am confident that the new framework based on the ESRB will provide a fundamental contribution in this respect. Enhanced interaction among macro-prudential bodies, between them and the micro-prudential authorities, and between macro-prudential and monetary policy authorities will be crucial.

With reference to the ECB's Securities Market Programme, suffice it to say that developments in financial markets called for special interventions. The programme is in line with the shared principles of European monetary policy-making and does not represent a change in the monetary policy stance. The current financial crisis has been described as valuation crisis. In fact, bond spreads for several euro-area countries widened beyond any reasonable level, and severe tensions in the bond market hampered the monetary policy transmission mechanism, demanding action by the central bank. However, a very important and more immediate issue is the exit from the exceptional monetary policy measures that have been adopted. All the various non-conventional measures that central banks, including the ECB, have taken over the last years have been directed at avoiding a financial and economic collapse. That collapse has not materialized. The relevant issue now is the timing and speed of the exit from these measures. This will have to be guided, on the one hand, by the need to maintain support for the orderly functioning of the money and financial markets and to sustain credit flows to the economy, and, on the other hand, by the need to avoid introducing distortions into the system and sowing the seeds of future imbalances. In the euro area, our "credit enhancing" policy was almost entirely based on temporary refinancing to the banking system and can easily be unwound. Indeed, gradual phasing out has started with the maturity of the six-month and twelve-month operations. The speed with which the exit will proceed will depend on how quickly financial markets get back to normality, on the pace of the economic recovery, on banks' ability to obtain stable funding from private capital markets.

Finally, as Balcerowicz forcefully argues, an adequate response to debt distress requires to counter with decision the ongoing erosion of fiscal discipline. Structural reforms that are perceived as capable of enhancing a country's adjustment possibilities, such as those that would lead to the removal of unnecessary administrative barriers, a higher efficiency of public services and a substantial improvement of the education system, are also of fundamental importance. Furthermore, in the market perception what matters most for debt sustainability is the ability to implement specific initiatives, capable of affecting the medium- to long-term growth possibilities of a country as well as the trends in its public expenditures, rather than the (ephemeral) short-term flexibility of its (nominal) exchange rate. This is what is shown, *inter alia*, by the Italian experience of 1992-95, when the adoption of a critical pension reform was what really mattered to convince markets of the return to a sustainable trend in public finances.

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