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A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area

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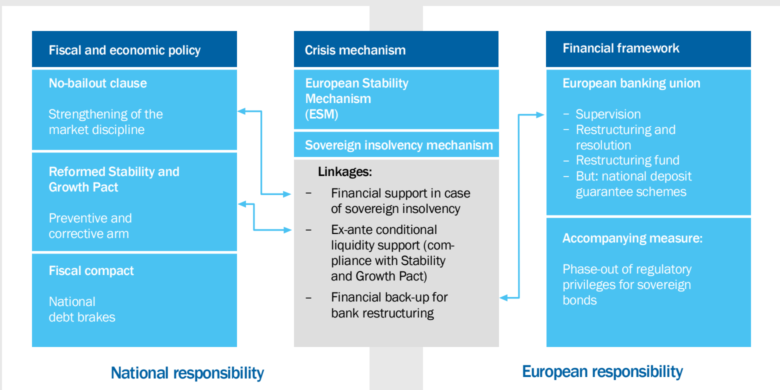
GCEE proposal „Maastricht 2.0“ : Necessary elements for a stable framework that retains national fiscal sovereignty.



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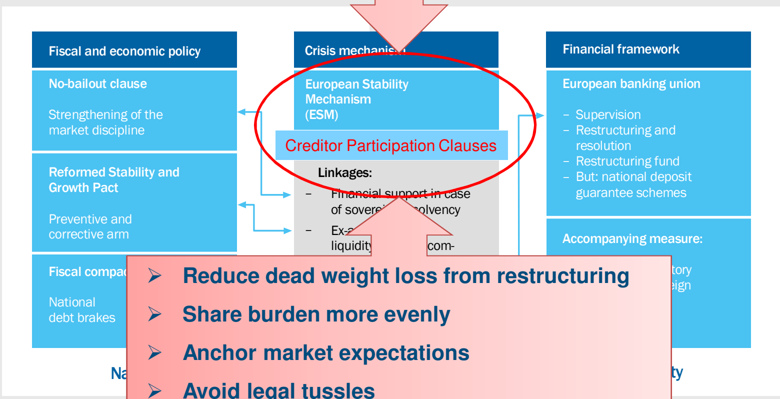
GCEE pre... ments for a stable fr... vereignty.

Bail-in invoked as part of ESM programmes

- ➢ **Enhance ESM fire power**
- ➢ **Protect ESM funds**



- ➢ **Reduce dead weight loss from restructuring**
- ➢ **Share burden more evenly**
- ➢ **Anchor market expectations**
- ➢ **Avoid legal tussles**

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Example: Euro area Troika programmes

- €142 billion for debt repayments as per initial programme projection
- 62 (Greece), 21 (Ireland), and 64 % (Portugal) of total funding needs

Financing needs[1] during the crises in Greece, Ireland and Portugal

1 – Sum of general government deficit and amortisation of long-term debt securities. 2 – Greece: including PE borrowing need.
a – May - December. b – January - June. c – Including December 2010. d – June - December.

Sources: European Commission and own calculations

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Existing proposals (selection)

Proposal	Year	Authors	What aspects does the proposal address? Setting triggers	Calibrating debt relief	Preventing holdouts	Facilitate transition
European Debt Restructuring Mechanism	2010	Weder di Mauro, Zettelmeyer	ESM, 2 hard thresholds			
European Crisis Resolution Mechanism (ECRM)	2010	Gianviti, Krueger, Pisany-Ferry, Sapri, von Hagen	Court decides		Court decides	New debt
European Monetary Fund (EMF)	2010	Gros, Mayer	EMF	Guarantee <60% GDP		
European Stability Mechanism	2011	Corsetti, Devereux, Hassler, Saint-Paul, Sinn, Sturm, Vives	ESM, soft 3-stage	Market prices	CACs	
Trigger clauses	2011	Weber, Ulbrich, Wendorff	ESM	3-year extension	Bond clause	
European Sovereign Debt Restructuring Mechanism	2013	Buchheit, Gelpern, Gulati, Panizza, Weder di Mauro, Zettelmeyer	ESM, hard threshold		Immunity clause	Redemption fund
Viable Insolvency Procedure for Sovereigns	2014	Fuest, Heinemann, Schroeder	ESM, soft		CACs + immunity	Wait until 2030
MEZ proposal	2015	Corsetti, Feld, Lane, Reichlin, Rey, Vayanos, Weder di Mauro	ESM, hard thresholds			Debt buyback

Source: Authors.

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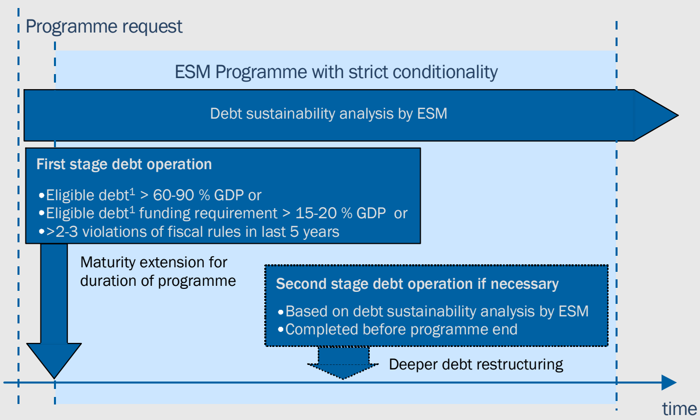
Time line



1 – Newly issued debt including Creditor Participation Clauses.

Source: Authors

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Implementation

- Principle of private sector involvement already in place

  Preamble (12), ESM Treaty: "In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered."

  - Mirroring IMF new lending framework agreed by 189 member countries

- Legal/regulatory foundation
  - New class of bonds with single-limb voting CACs
  - Enforcement moratorium to be anchored in ESM Treaty
  - Also: retain possibility to restructure old debt and limit coupon payments
  - Also: phase out privileges for sovereign exposures in banking regulations
  - Also: keep ECB liquidity window open to bonds with maturity extension

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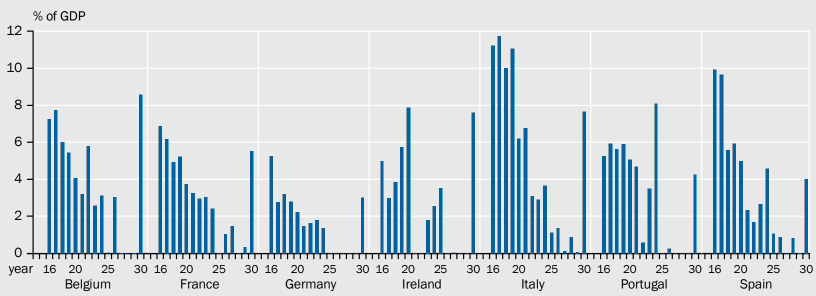
Phase-in (1)

- Transition: phase-in through introduction of new clauses
  - Applies only to sovereign bonds issued by central governments

Maturing long term sovereign bonds[1]



1 – Sample of long term sovereign bonds issued by central governments since 1999 as of end-2014. Figure for year 2030 includes all amounts maturing in 2030 or later in % of 2030 GDP.

Source: Eidam (2016)

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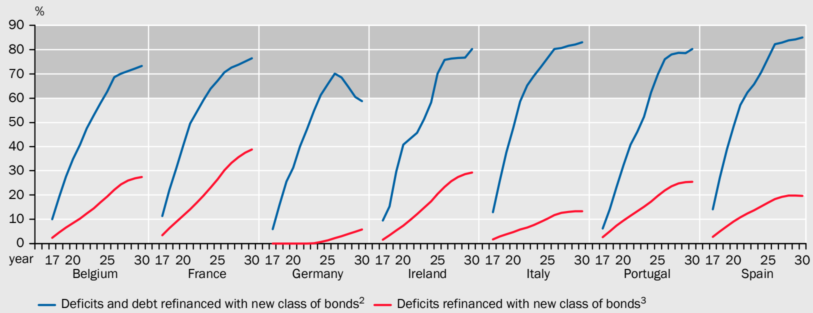
Phase-in (2)

Penetration of debt stock with bonds including Creditor Participation Clauses (CPCs) issued from 2017[1]



1 – Assumes bonds are issued with new clauses starting in 2017 based on maturity profile for bonds as of end-2014, with (i) maturity of newly issued bonds similar to 2014 and (ii) nominal debt following European Commission (2015) and extrapolated from 2027. 2 – Assumes that shares of other debt relative to GDP remain constant. 3 – Deficits until 2026 based on European Commission (2015), and converging towards 0.5% of GDP at a speed of 0.5 percentage points afterwards. Bonds with CPCs falling due are rolled into similar bonds.

Source: Eidam (2016)

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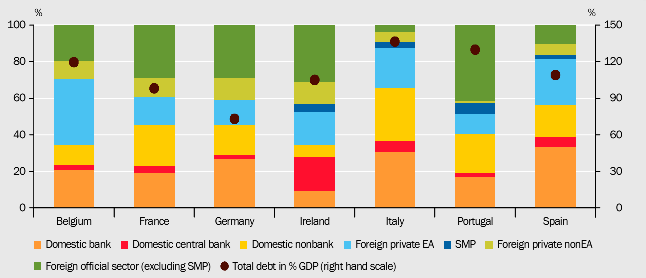
Who shares the burden?

Holders of advanced economy government debts, 2015Q2[1]



1 – Fractions of EA-holdings from last available year, most countries end-2014; Belgium, Italy, Portugal, Spain: from end-2013. SMP-holdings are calculated using the total reported values at 3 July 2015 and the breakdown by issuer of the outstanding amounts of the Eurosystem's SMP-holdings as of end-2014.

Sources: Arslanalp und Tsuda (2012), ECB, CPIS Database, and own calculations

- Mostly intra-euro holdings differ from EM restructurings, but:
  - Too big to be saved issue (e.g., Italy?)
  - Reduce uncertainty (-> indirect spillovers)

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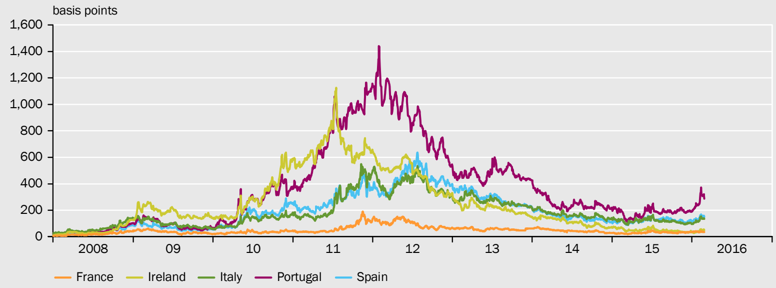
What are the risks of spillovers?

Interest rate spreads on government bonds compared to Germany[1]



1 – Differences between the yield on 10-year government bonds of each country relative to German government bonds.

Source: Thomson Financial Datastream

- Serious valuation effects even absent restructuring mechanism

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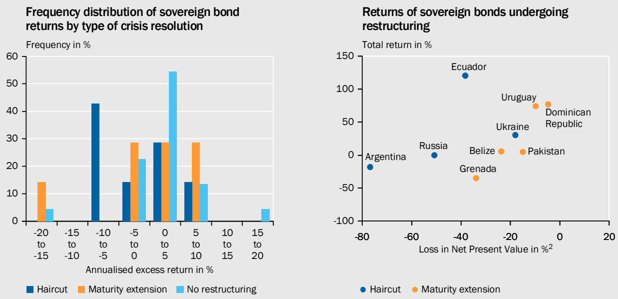
How serious are losses in the long run?

- Long-term investors can benefit from upside following crisis resolution

Long term returns of sovereign bonds during debt crises[1]



1 –Returns during a time window starting 200 trading days prior to crisis and ending 200 days after crisis end. Sample countries include Argentina (1998, 2001–2005, 2008), Belize (2006, 2088, 2011), Brazil (1998, 2002), Bulgaria (1998), Colombia (1998, 2002), Dominican Republic (2003–2005), Ecuador (1998), Gabon (2008), Ghana (2008), Grenada (2004), Iraq (2008), Jamaica (2008), Lebanon (2001), Nigeria (1998), Pakistan (1998, 2008), Russia (1998–2000), Serbia (2008), Seychelles (2008), Sri Lanka (2008), Turkey (2001), Ukraine (1998, 2008), Uruguay (2002), Venezuela (1998), and Vietnam (2008). 2 – According to Trebesch and Cruces (2013).

Source: Andritzky and Schumacher (forthcoming)

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Complementary measures and questions

- Mechanism for clear rules of the game, augmented by…
  - Phase out regulatory privileges (home bias may be endogenous)
  - Promote creation of buffers, e.g. insurance sector?
  - Apply stress test and crisis simulations
- Does the mechanism deter requests for ESM assistance?
  - More room for gradual fiscal adjustment and longer programmes
  - ESM programme needs to take spillovers into account
  - No decision on deeper restructuring needed at ESM programme inception
- What about fiscal discretion and funding costs?
  - No Trojan horse to restrain fiscal policy, national responsibility for fiscal policy
  - Scarce evidence for general increase in funding cost or market volatility

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Thank you!

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