European Debt Crisis

Princeton Panel

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Overcoming the crisis

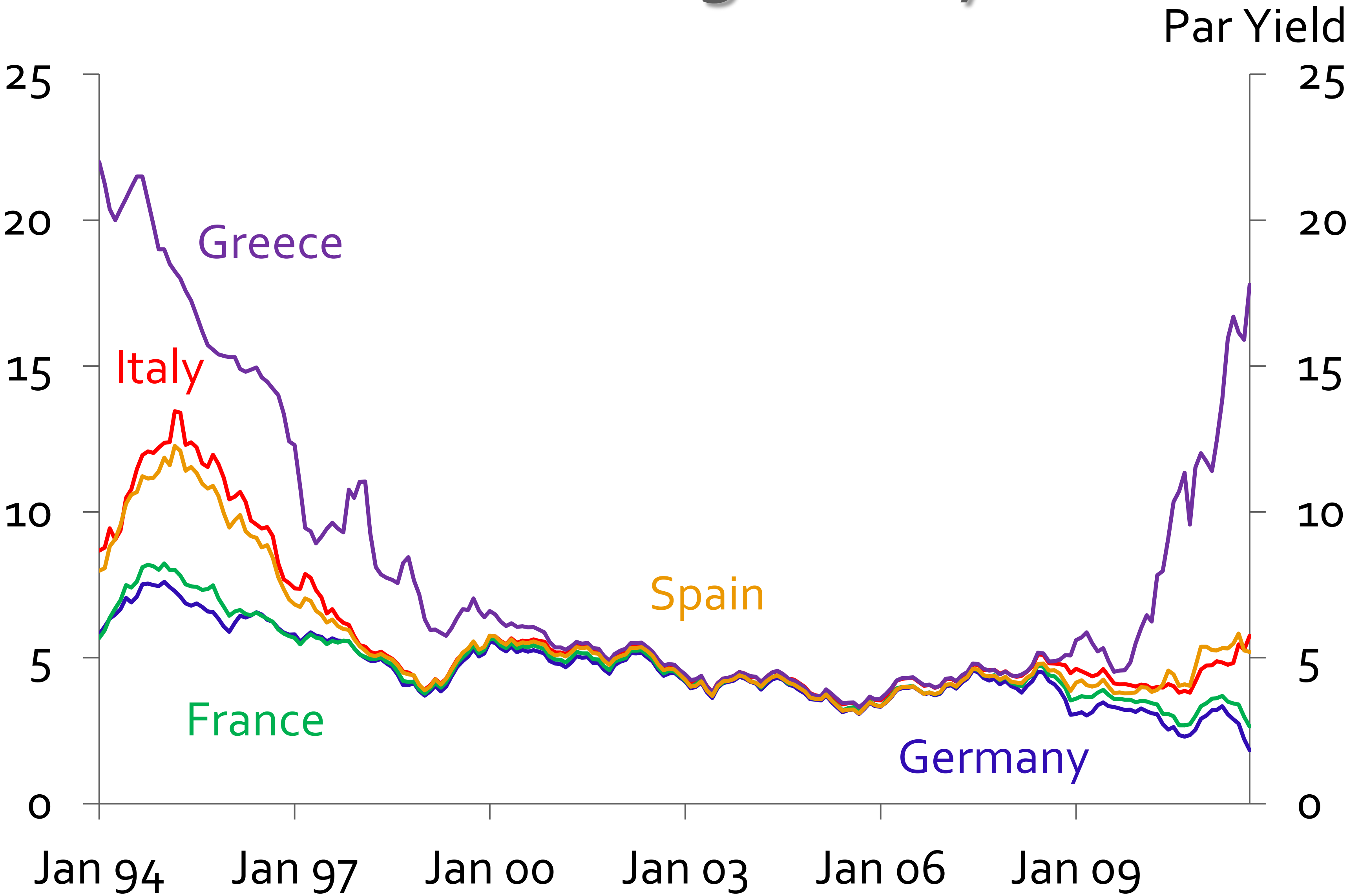
- backwards induction approach:

1. Diagnosis – how did we get there?
   - Run-up phase
   - Crisis phase

2. Give long-run perspective
   - Banking landscape (ESBies, European FDIC, resolution,…)
   - Monetary framework
   - Fiscal coordination

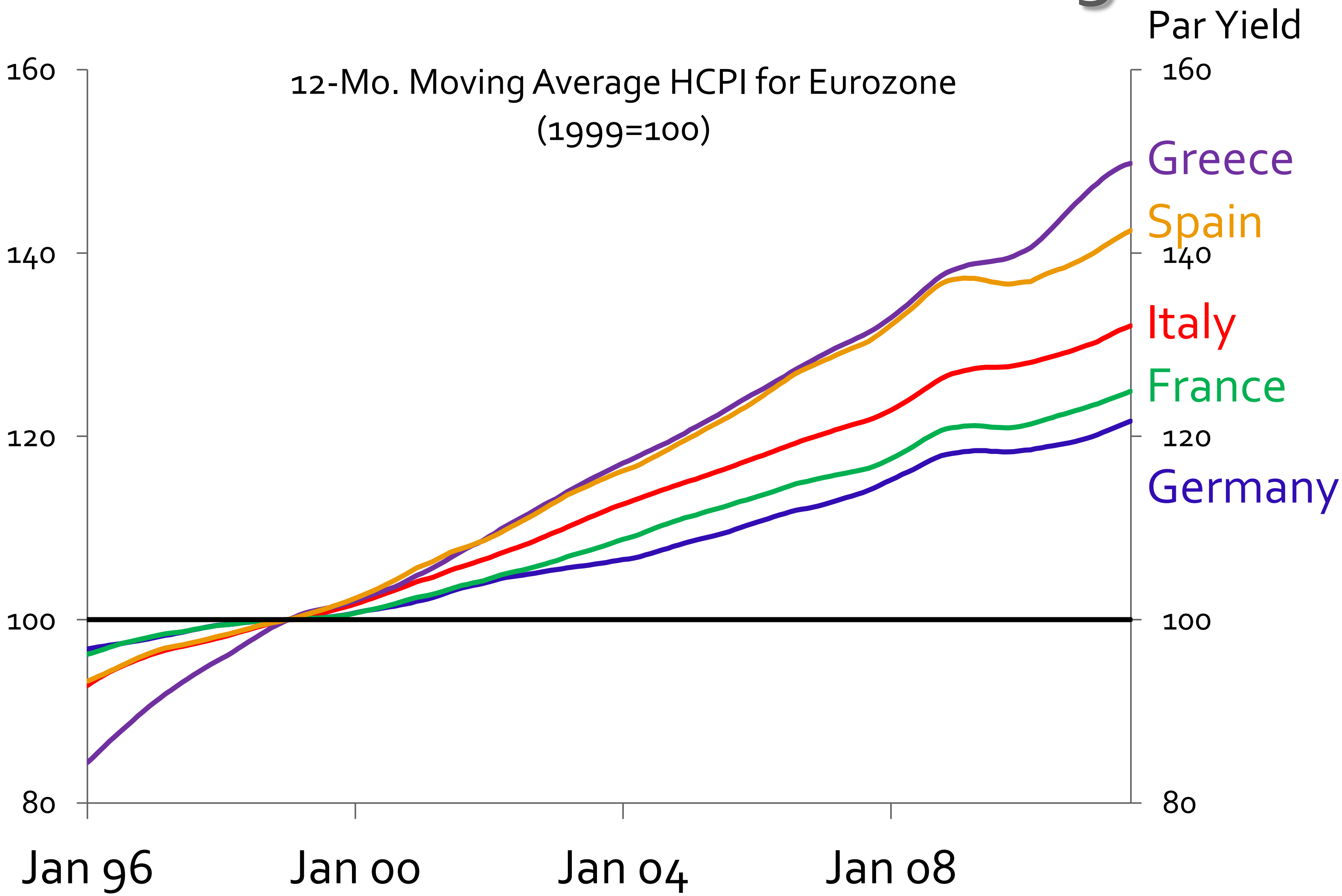
3. Transition to long-run

Eurozone: 10Y Sovereign debt yield



Source: Eurostat

Eurozone: Persistent Inflation Divergence



Source: IMF

Real interest rate gap

Average rates 99-07	Germany	Spain	Greece
Nominal interest rate	3.8%	3.9%	4.4%
Inflation rate	1.8%	3.3%	3.5%
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Real interest rate	2.0%	0.6%	0.9%

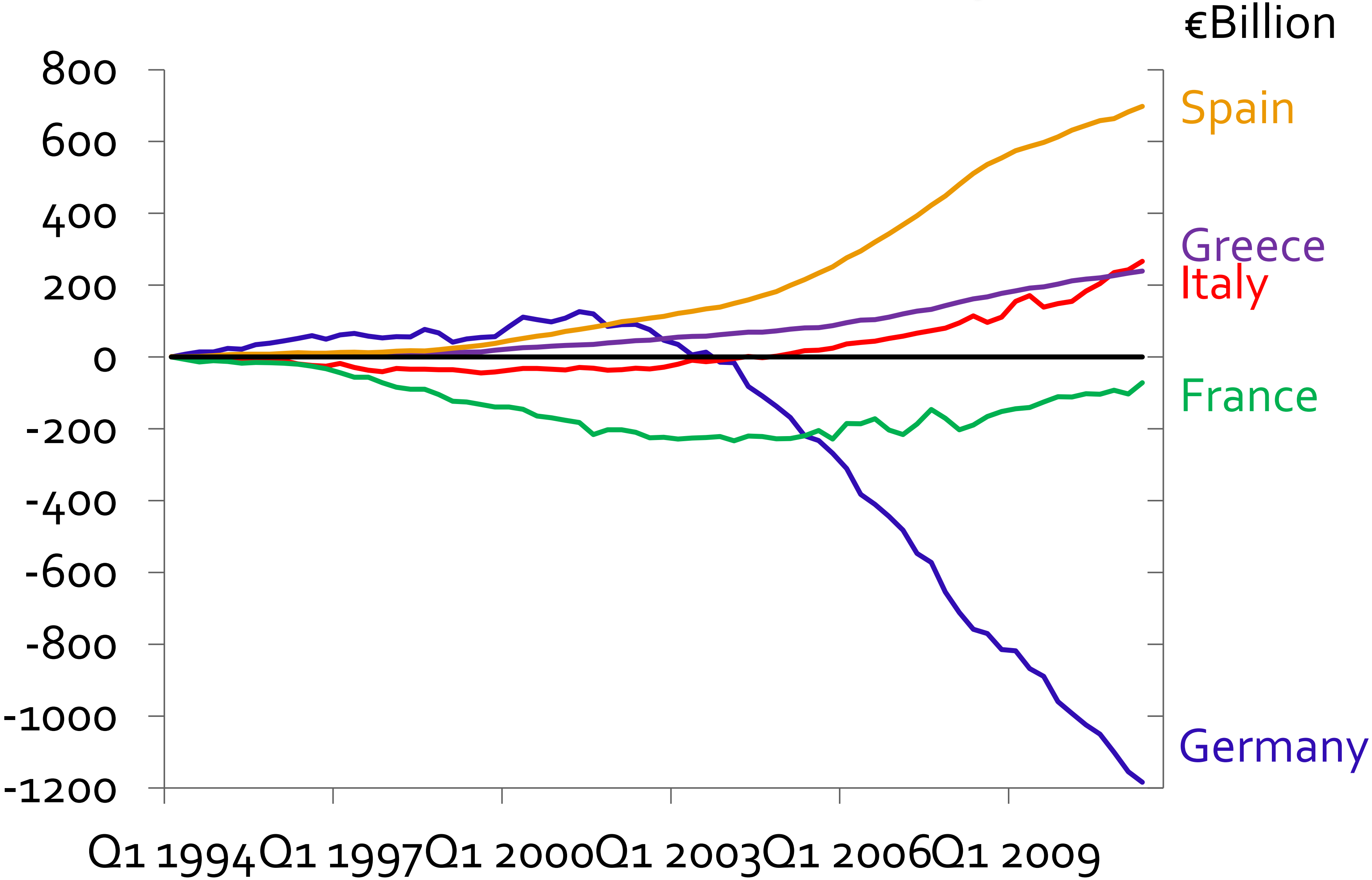
Rate for German savers > Rate for Spanish/Greek borrowers (Government)

Risk charge for sovereign debt = 0

Consequence: larger savings in Germany + capital outflows boost to Spanish economy & inflation

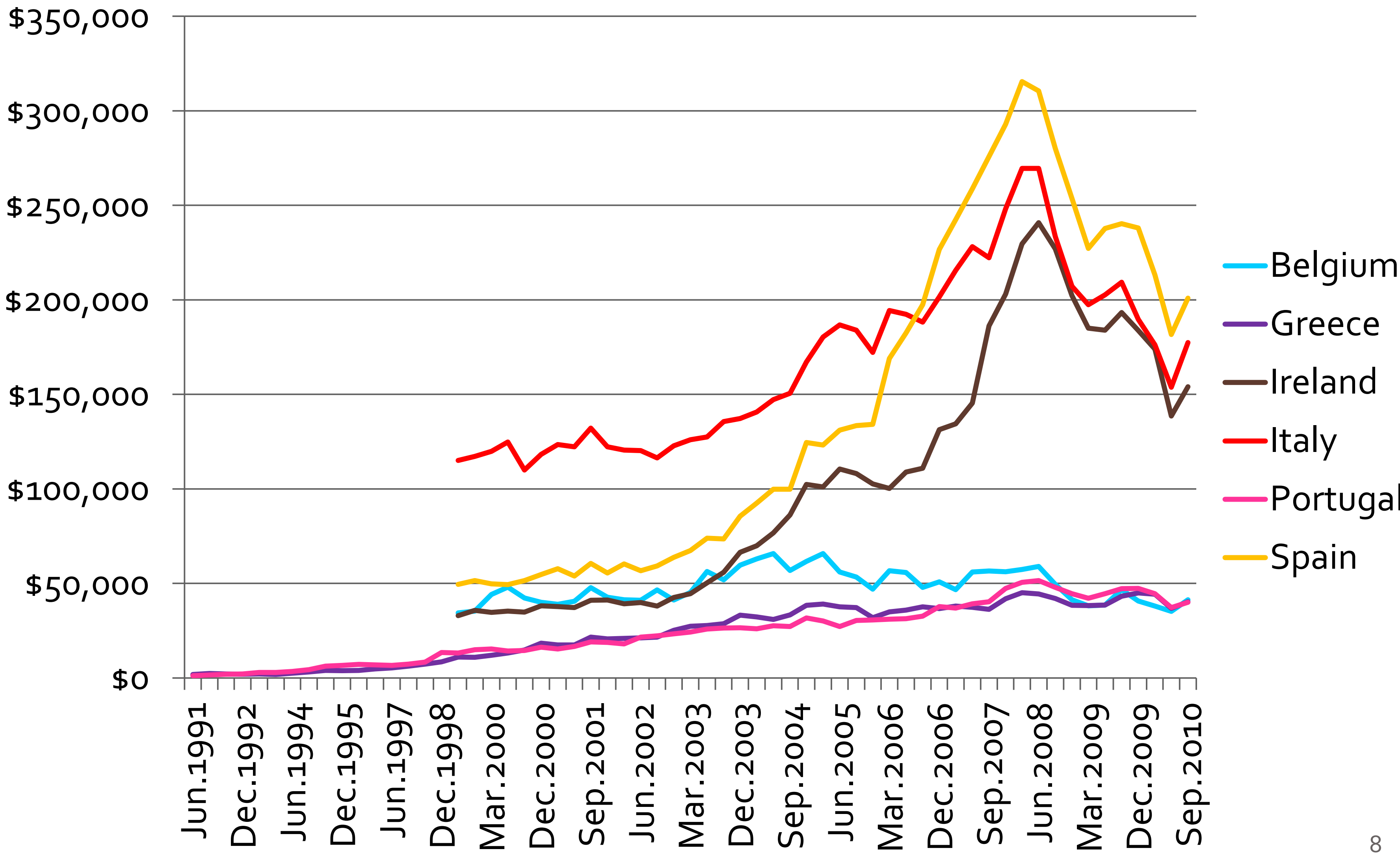
Source: Bloomberg 5 year government note indices

Eurozone Accumulated Net Capital Inflows

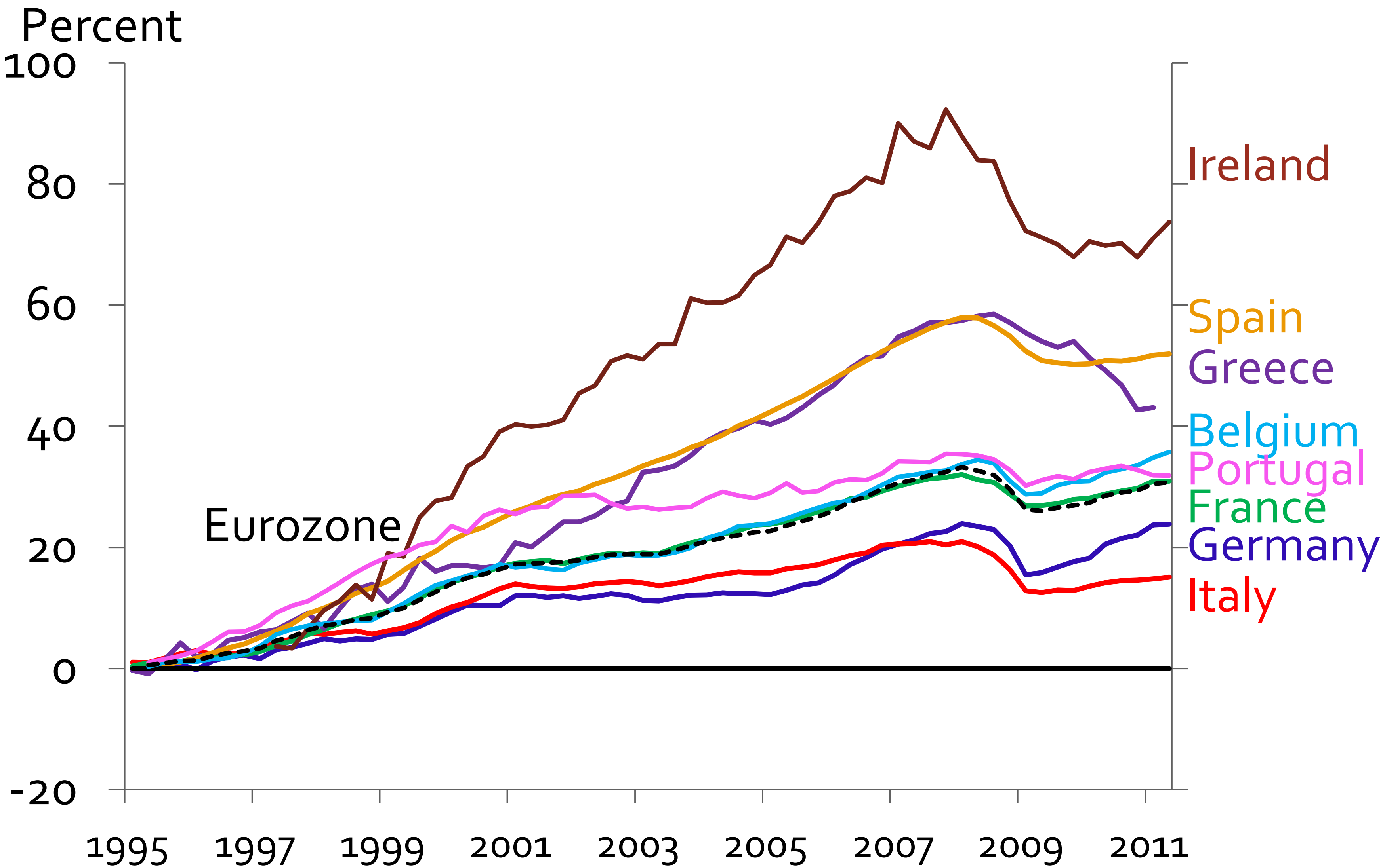


Source: Eurostat

German Foreign Claims



Eurozone: Accumulated GDP Growth

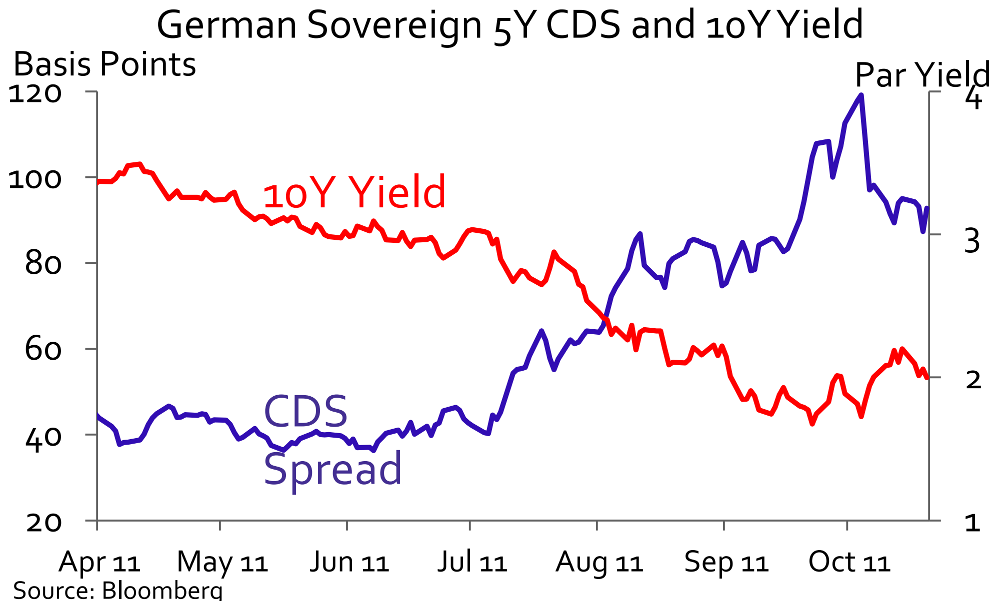


Source: OECD

Crisis diagnosis 1: Flight to safety

- Today: asymmetric shifts across borders
  - Value of German bund/French debt increases
    - German CDS spread rises, but yield on German Bund drops (flight to safety)
  - Value of Italian/Spanish/Greek… sovereign debt declines

Crisis diagnosis 1: Flight to safety



- Today: asymmetric shifts across borders
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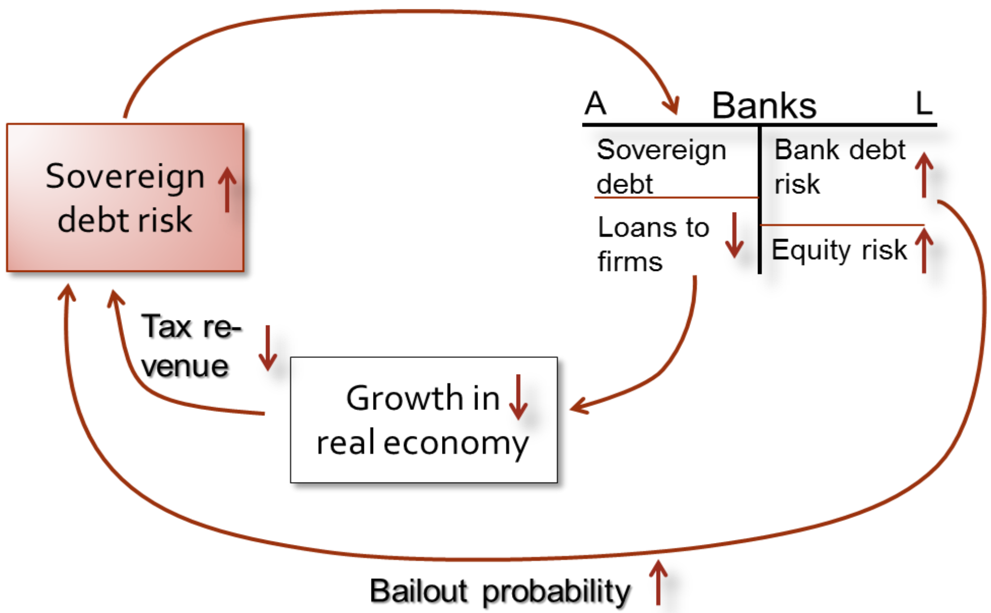
Crisis diagnosis 2: Diabolic Loop

Contagion due to diabolic loop – “twin crisis”



- Trigger
  - Bank insolvency (Ireland, Spain)
  - Public debt/slow growth (Greece, Portugal, Italy)

Banks need risk-free asset for transactions (best collateral)

Distortions - Inconsistency

- Sovereign debt is treated as safe asset
  - Basel: Zero risk-weight (for own sovereign)
  - ECB: Low haircut
    e.g. 10 year Greek bond has 10% haircut

- Concentration of sovereign risk in banks

- Inconsistency
  - No-bailout clause
  - Zero risk weight

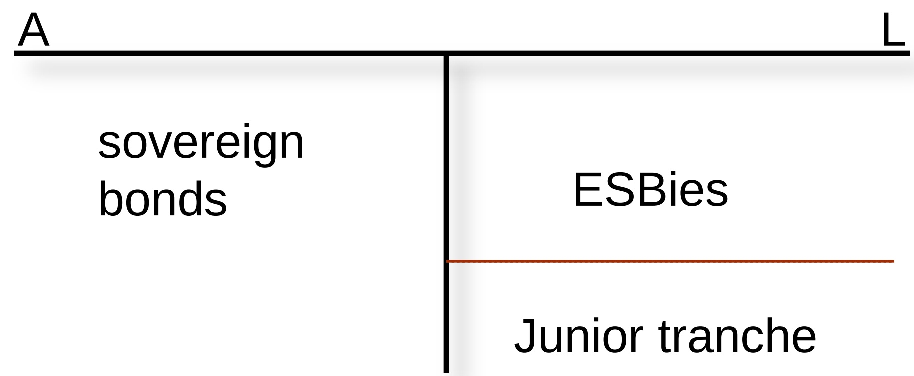
ESBies proposal

9 economists: www.euro-nomics.com

1. Create "safe" asset
   - With "flight to quality" correlation structure
   - ⇨ Remove pressure for capital flows across borders channel them across different tranches
2. Appropriate risk weights + haircuts for sovereign debt
   - ⇨ Break diabolic loop

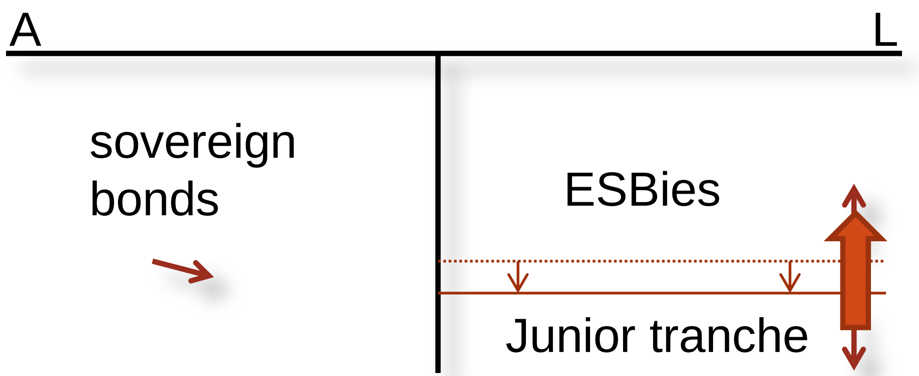
- Part of bigger proposal
  - European FDIC, bank resolution, etc.

ESBies structure



- up to 60% of GDP (5 year average) from all Euro-members
- ESBies – “flight to quality/safety asset” – *coordination!*
  - Basel: zero weight
  - ECB: preferred asset to conduct open market operations
- No control rights for junior tranche!

Flight to safety: in times of crisis



- Today: asymmetric shifts across borders
  - Value of German bund/French debt increases
    - German CDS spread rises, but yield on bund drops (flight to quality)
  - Value of Italian/Spanish/Greek… sovereign debt declines
- With ESBies: Negative co-movement across tranches
  - Value of ESBies tranche expands – due to flight to quality
  - Value of Junior tranche shrinks – due to increased risk
  - Asset side is more stable

How to create value?

- "Flight to safety fluctuations" are reduced
  - No negative distributional effects away from Greece, Italy, … towards Germany in times of crisis
  - Can be used in current transition phase!
- ESBies' liquidity premium in normal times (ex-ante)
  - Estimates: 0.7% in normal times
  - Shared across all euro-members
  - Advantages in crisis times are much larger
    - Especially for peripheral countries!

Transition phase

- Give long-run perspective
- Phase in
  - ESBies (market has to learn about junior tranche)
  - Increase in capital requirements
- Swap existing holding of sovereign debt for ESBies (at market prices after price adjustment due to ESBies proposal)
- Recapitalization of banks
  - Now smaller --- but there is no way around it
  - “mandated” private (to avoid stigma) + public backup
    - Similar to U.S. in spring 2009 after SCAP
  - Has to be done in coordinate fashion – otherwise free-riding

Conclusion: Guiding Principles

- Reduce "flight to safety" capital flow fluctuations – coordinate on new asset
- Isolate banks from sovereign risk - avoid diabolic loop
  - Higher risk charges for sovereign debt are essential!
- Don't distort incentives for sovereigns
  - Interest rate signal as corrective (market) force should remain intact
- Stable **credible** and transparent rule for portfolio weights
  - Fixed rule based on easily measurable units (e.g. (lagged) GDP or ECB key)
  - Change require anonymity of parliamentary approval and go along with change in voting power (change in ECB key)
- Avoid procyclicality
    - Set tranching points conservatively (in good times) in order to have buffer for bad times – note that correlation will shoot up in times of crisis!
- Extra "Sweetener" for transition phase
  - Take advantage of liquidity premium
- Not a guiding principle
  - Maximize size of ESBIES tranche