Euro Area Sovereign Default Mechanisms: Mind the Trap

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Euro area SDRM debate and the ESM Treaty

- First euro area SDRM proposal appeared in 2010-2011
- Debate picked up in 2014-16, with several working papers.
- Pre-ESM proposals vs. post-ESM refinements
- Connection with IMF papers on SDRMs and CACs
- Argument is: ESM Treaty omits formal insolvency procedures…
- … and also suffers from so-called 'holdout problem'

Key features of euro area SDRM proposals

- Introduce explicit insolvency procedues, preferably in ESM Treaty
- Debt rescheduling/restructuring as a precondition for ESM support
- Debt maturity extension is automatic in some proposals (Weber et al.)
- Quantitative thresholds that trigger restructuring (e.g. 90% debt/GDP)
- Reforming CACs: from ‘two limb’ to ’single limb’ voting procedure
- Gradual phasing-in of new regime with full implementation by 2030

Not just an academic fad

- German Fin Min sets conditions for Banking Union implementation
- SDRM to be accompanied by curbs on banks’ sovereign exposures
- The goal is to improve resilience of euro area financial system…
- … in the face of little or no progress on debt-to-GDP ratios

Implications for monetary policy and financial stability

- No-bailout clause vs. financial stability role of ECB
- ESM primary market support is a precondition for OMT support
- Yet-to-be-used OMT is crucially important in countering ‘breakup risk’
- If restructuring was automatic, bond market would lack a safety net
- Debt restructuring is already an option in ESM framework…
- … but it is, rightly, surrounded by ‘constructive ambiguity.’

Constructive ambiguity vs. explicit insolvency procedures

- Sustainability is a complex concept, cannot be captured by one indicator, e.g. debt/GDP ratio, and can evolve over time.
- Rigid rules based on debt/GDP would reduce ‘Type I’ errors but raise the probability of ‘Type II’ errors.
- Consequences of ‘Type II’ are underestimated by SDRM authors
- Comparison between Greece 2012 and Argentina 2002 highlights difference between default inside EMU and with flexible exchange rate
- Constructive ambiguity is typical of all *fiat money* monetary regimes
- **Debt restructuring should be a measure of very last resort in EMU**

Case for reforming CACs is tenuous at best

- CACs in euro area sovereign bonds were introduced in 2013
- In Italy's case, CAC bonds represent 42% of outstanding securities
- Changing CACs would further segment the bond market…
- … and may hurt investor confidence at a critical juncture
- SDRM proponents wish to resolve so-called 'holdout' problem
- But sovereign issue sizes are large, difficult to form blocking minorities
- … and issuer has the option of launching a bond-by-bond restructuring

Conclusions

- No reason to amend the ESM Treaty at this stage, CACs included.
- Automaticity between ESM application and default should be ruled out
- Clarification of insolvency procedure could be at most an add-on…
- … in return for measures that would enhance solvency via growth
- Instead of requiring 'fiscal trasfers' or risk-sharing…
- … greater leeway to support re-industrialisation of economy.
- Incentives, not just penalties to foster compliance with debt rule.