EUROZONE's STRUCTURAL WEAKNESSES IN DEALING WITH SOVEREING DEBT AND BANK NPLs AND SOME REMEDIES

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THE EX POST DIAGNOSIS: AN IMBALANCED MONETARY UNION AND FOUR INTERLOCKING CRISES

- Predominantly a **banking crisis** which led to public bailouts (Ireland, Spain, Cyprus)
- **Competitiveness crisis** which is not simply translated to loss of fiscal revenue and widening fiscal deficits and debt accumulations (Greece, Portugal, Spain)
- It also leads to **massive payment imbalances** within the Eurozone (Germany, Finland, the Netherlands vs the European south), and surpluses had to be invested and were invested in real estate bubbles in Ireland and Spain and to finance budget deficits – as a result most of EU public debt is intra-EU
- Accumulating public debt to the point of unsustainability: **sovereign debt crisis**

Major Intellectual Flaws but hindsight is 20/20

- Financial markets are efficient and can absorb shocks through market discipline and interest rates
- In a currency union there are no runs on member states as the stronger members preserve the value of the currency
- A currency union alleviates competitiveness gaps and balance of payments disparities through factor mobility
- Current account imbalances do not count because they do not trigger a run on the currency as in the case of countries with own currency where both foreign and domestic capital is withdrawn from the economy
- There can be no balance of payments crisis in the sense as those that occurred in fixed exchange rate systems because in a monetary union internal foreign exchange markets have disappeared.

In Reality (i)

- When in a monetary Union 'the fiscal position of a country deteriorates, e.g. due to the deflationary effects of an internal devaluation, investors may be gripped by fear leading to a collective movement of distrust.
- The ensuing bond sales lead to a liquidity squeeze in the country concerned.
- This "sudden stop" in turn leads to a situation in which the government of the distressed country finds it impossible to fund its outstanding debt except at prohibitively high interest rates.' (Paul De Grauwe)

In reality (ii): booms and busts and the impossibility of adjustment

- The dynamics of booms and busts continued to work at the national level and and busts.
- No stabilizers and no pain free & effective solution
  - the less competitive members cannot depreciate their currency to increase the value of imports and make their exports more attractive
  - Decreasing the cost of production to boost competitiveness entails massive social and political costs
  - If other members are not importing internal depreciation is fruitless
- In the absence of investment to boost productivity in the less competitive members and in the absence of common fiscal governance structures (including fiscal redistribution mechanisms), fiscal divergences in a common currency area normally worsen instead of improving

In reality (iii)

- Financial markets are prone to crisis and market discipline can break down either as a result of fads, herding and panics or due to existence of too-big-to-fail banks
- The era of great moderation – Jackson Hole consensus [is not (always) working]: it facilitated the formation of asset bubbles
- Optimal currency areas! Are there any?
- Factor mobility: is it all what it holds to be, skills and path dependence are of no relevance??!!!
- Current account imbalances count even within a currency union because a confidence run on the suffering member state is inevitable as is its amplification to the monetary union

What's missing from the EMU institutional puzzle work

- Apart from the mooted single fiscal authority as a preliminary step to Eurobonds the EU requires
- A mechanism for tackling sovereign over-indebtedness (ESM plus)
- A mechanism for tackling debt overhang

AN EMF?

- The EU Commission proposed in December 2017 an EMF which is based on an idea by D. Gros and T. Mayer in 2010 in connection with the sovereign debt crisis
- The Commission deems its proposals as a natural response to shortcomings of eurozone governance and as an initiative that ensures that Europe takes its future into its own hands (J-C Juncker echoing calls from the French president Emmanuel Macron for the bloc to assert its "economic sovereignty")
- The EMF would take over the functions of the European Stability Mechanism, which has acted as the euro area's leveraged sovereign lender of last resort rather bailout fund, as all ESM loans have to be repaid in full.
- It will also conduct secondary market operations for the bonds of a troubled member state that has sought EMF lending – i.e. replacing Draghi's "whatever it takes" with a forall programme and conditionality
- The EMF would be in charge of a planned last-resort financial backstop for the euro area's system for handling banking crisis and will provide liquidity funding for bank resolution
- It would also play a bigger role in monitoring countries' compliance with the conditions of their bailout programmes.
- The Commission wants governments to adopt the legislation to set up the EMF by mid-2019.

How about conditionality?

- Conditionality monitoring is for the Commission to keep.
- According to Art. 13 of the proposed EMF Statute, conditionality is negotiated by the Commission, in liaison with the ECB, and "in cooperation with the EMF".
- "Cooperation" is admittedly a very weak form of involvement, especially if it's compared with the phrase "together with" that previously described IMF involvement in the ESMT.
- Moreover, MoUs shall be signed both by the Commission and the EMF. With the ESM, in contrast, MoUs where signed by the Commission "on behalf" of the ESM. The phrase "on behalf", establishing an agent-principal relation between Commission and the ESM, is now stricken out, meaning that the Commission becomes legally a co-owner of EMF conditionality.
- Finally, under the proposed EMF Statute, compliance with conditionality is being monitored solely by the Commission, in liaison with the ECB. No role is explicitly provided for the EMF in this critical phase.

A ‘stabilisation function’ for troubled economies &money for reform

- The commission has identified public investment — rather than unemployment reinsurance money or other emergency government spending — as the least politically contentious way to help out any member state hit by an economic “shock”.
- The proposal envisages a mixture of loans and grants and the establishment of a “dedicated vehicle” to tap different funding sources, including loans guaranteed by the EU budget or provided by the EMF. The EU could also establish an “insurance mechanism” based on voluntary national contributions. Brussels estimates that for the system to be effective it would need to be able to make net payments equivalent to at least 1 per cent of the country’s gross domestic product.
- In an effort to make the plan more appealing to Germany and other fiscal hawks, compliance with commitments made under the euro area’s fiscal rules would be a precondition for getting help. The commission stresses that its system avoids “permanent fiscal transfers” between countries.

Money for reform

- The commission plans also hint at revamping spending of the EU's large regional aid funds. It plans to improve incentives for governments to make "structural reforms" by rewarding the member states that have the best records on reforming economies and labour markets.
- The plans say "extra grants" could be provided for countries that deliver on "multiannual reform commitment packages" agreed with Brussels. In that regard, the proposals provide carrots and sticks to governments — offering cheap loans and grants for tough times on the one hand, and beefing up the conditionality attached to other parts of the EU budget on the other.
- One priority is to encourage governments to undertake reforms to tackle excessive macroeconomic imbalances, such as running a large current account deficit

How an EMF should look like to be acceptable to Germany?

- Fuest (Ifo)
  - No burden sharing –no transfers
  - Moreover,
  - Firstly, supervision of the debt rules should be transferred from the European Commission to the EMF to de-politicise the process. The issue of whether states have violated debt rules is a matter of hard facts, not political assessment.
  - Secondly, the EMF should discuss the emerging risks to financial stability in regular consultations with the euro member states and publish protocols of these discussions, following the IMF's example with its article IV consultations.
  - Thirdly, private investors must be held liable for over-indebted states and banks. This means that banks need to hold more equity capital and fewer government bonds, otherwise liability in the case of state bankruptcies could trigger a banking crisis. A combination of equity cover and diversification regulations could induce banks to toe the line.

The 14 economists

- 1) **The completion of banking and capital market union**, via measures including the introduction of common deposit insurance but with a *sovereign concentration charge*. This would require banks to post more capital if debt issued by a single creditor – such as the home-country sovereign – exceeds a certain proportion of their balance sheet. This would cut through the "doom loop" that makes banks and sovereigns interdependent.
- 2) **A new expenditure rule to replace Maastricht deficit criteria** Governments that violate the rule would be required to finance excess spending using junior bonds (*accountability bonds*).
- 3) **Laying the foundation for orderly debt restructuring** for countries whose solvency cannot be restored with conditional bail-out funds. The policies and conditions of the ESM fund must ensure that countries with unsustainable debt levels do not receive any bail-out credit.
- 4) **A new joint fund to support individual countries experiencing a large-scale crisis.** Member countries would pay into a fund, with countries particularly prone to major economic disturbances paying disproportionate contributions. If employment plunges and/or unemployment rises above a high, fixed threshold, the country in question can draw on the fund.
- 5) **A synthetic euro-area safe asset that would offer investors an alternative to sovereign bonds**
- 6) **Reform of institutions: assigning the Eurogroup presidency role to the Commission**

A critique of the proposals of the 14

- They do not address the issue of boom-and-bust cycles in the euro area;
- Same mistakes again: they place too much trust in the ability of financial markets to stabilise national economies and to discipline governments in a sensible way
- Synthetic asset: financialisation and then more financialisation – a fictitious index asset bound to be multiplied in the futures markets is no solution to the problem of bank instability
- The proposed fiscal rules and rules for sovereign debt restructuring run the risk of reducing governments' policy space and room for maneuver/negotiation with creditors
- Their semi-automatic debt restructuring mechanism will trigger a generalised run on the sovereign debt of the weaker EZ economies precipitating instead of preventing a crisis

Finally Charles Wyplocz's (2017) objections to an EMF

- Moral hazard
- It would obliterate the no-bailout prohibition of Art. 125
- It would be too politicized
- The IMF does a better job
  - E.g. here is what was stated in the first Greek bailout package:
- "*In the wake of the crisis in Greece, the situation in financial markets is fragile and there was a risk of contagion which we needed to address. We have therefore taken the final steps of the support package for Greece, the establishment of a European stabilisation mechanism and a strong commitment to accelerated fiscal consolidation, where warranted*." (Economic and Financial Council, Council Conclusions, Brussels 9-10 May 2010). Thus the rescue's objectives were to calm financial markets down, to prevent contagion and to speed up fiscal consolidation.
- So Nothing about improving the lot of the population
  - But here is what the IMF articles state:
- A core responsibility of the IMF is to provide loans to member countri*es experiencing actual or potential balance of payments problems. This financial assistance helps countries in their efforts to rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth, while undertaking policies to correct underlying* problems."

Is there a solution to the conundrum?

- Incentives and learning from other debt restructuring systems
- Money for reform should never become a tool for political “blackmail”
- Moving all bank resolution liquidity transfers to the ESF turning it a LoLR with sovereign conditionality added is a folly
- On the other hand, a country that is in serious macroeconomic and fiscal trouble and faces over-indebtedness is a country in need of serious governance reform as much as anything else
- Finally, while it is said that states can never go bankrupt unlike corporations but that’s not true for states that do not issue their debt in their national currency regardless of the value of their assets
  - E.g., the proceeds of the Greek privatization fund will go to satisfy the creditors
  - Countries face severe consequences:
  - You can change the government but not the policies
  - The threat of exit from the currency union

Sovereign Bankruptcy Reorganisation Mechanism & debtor & creditor protection (i)

- The EMU needs a Chapter 11 type of procedure for sovereigns with Debtor in Possession
- It protects the sovereign's essential payments but freezes payments to creditors which are automatically assumed by the ESM for a limited period of time to prevent defaults while the ailing country sorts out itself
- ESM offers any new (low interest – long maturity) loans that may be required until the country reemerges from bankruptcy protection
- The debtor must agree a reorganization plan to increase cash flows by increasing revenue (macroeconomic adjustment targeting growth) and cutting down expenditure before accepting ESM money.

Sovereign Bankruptcy Reorganisation Mechanism (ii)

- General parameters of conditionality emphasising governance reform would have to be pre-agreed to remove the margin for punitive measures
- The Greek recipe of raising taxes while cutting down public expenditure under conditions of a liquidity draught ought not to be repeated
- Pre-agreed template expressly provides that reorganisation starts from the banks
- Moral hazard is contained in two ways:
  - First, the country hands some macro-economic decision-making to the ESM & creditors' committees
  - Secondly, creditors know in advance that this might happen and adjust interest rates accordingly so that countries that wish to borrow cheaply adjust their expenditure ex ante
  - Governance reform would spell the death for incumbent elites which thus would push for ex ante adjustment

Aid Return to growth -

- EZ is showing signs of recovery which has to be reinforced
- How?
- By tackling the 1 trn mountain of NPLs &
- resolving the debt overhang
- How?
- An AMC scheme with burden sharing?

AMC obstacles in general

- Valuation and distribution of losses –
  - if net book value the AMC loses disproportionately
  - if market value the bank will need massive equity injections or otherwise resolution and bail-in (even as an open bank process under the BRRD)
- Transparency and market for lemons situations
- Moral hazard – unless burden sharing
- Governance:
  - warehousing of bad credits of connected parties
  - providing a lifeline to "zombie companies negating the virtuous impact of resolving debt overhang
    - E.g., the PRC scheme

More on AMC Shortcomings

- the governance issue – mostly relating to a fear of cherry picking, or that the bad bank will be used to restructure loans to related parties at favourable terms, or to warehouse and hide worthless assets. This also a problem in the case of debt to equity swaps and could have as a result subsidising "zombie" companies" (IMF, 2016 on the challenges of Chinese scheme);
- limited transparency and uncertainty about the quality of bank disclosures and due diligence can give rise to a "market for lemons" situation;
- asset valuation – the choice of measures to be employed to calculate NPL value, e.g., market value, book value, net book value, or long-term economic value is a matter of great importance both for the success of the scheme and the distribution of losses. Of course, this is no simple matter as the rate of NPL recovery, especially vis-à-vis corporate and real estate loans, is also dependent on the prevailing conditions of demand in the market and the state of the macroeconomic cycle;
- ultimate loss absorption – which party will absorb any losses on liquidation and winding up.

AMC advantages for Corporate NPLs (in general)

- A sound track record of earlier use in the Scandinavian and Asian banking crises – also Ireland
- Clean cut solution – a ceiling is placed on bank losses
  - It provides certainty to equity and bond market investors about the state of bank balance sheets
- Lending resumes as the debt overhang recedes
  - Debt overhang is eating percentage points from GDP growth as opportunity fo new investment is passed up
  - A liquidity draught serious impediment to the recovery of the EZ periphery
- It aids turnarounds
  - Economies of scale in hiring PE workout skills
  - Single point of decision-making
- An radical solution frees up very considerable management time as most of it right now in the high NPL ratio countries is dedicated to NPL management and resolution
- Economies of scale in debt marketing and issuance – aids the creation of a liquid market for NPLs

AMC advantages (for Corporate NPLs) in the EZ (ii)

- **Can lower the cost of funding for banks**
  - In countries like Greece it aids the repatriation of deposits (in conjunction with elimination of currency risk) making banks less dependent on ELA and lowering their cost of funding
  - **Investor confidence in bank solvency**
  - **Ease the burden on the ECB vis-à-vis purchase of banking assets**
- **Better co-ordination of restructuring of multiple claims**
  - Big corporate creditors will invariably hold loans from several domestic banks
  - Banks face asymmetrical incentives and a series of prisoner dilemmas in co-ordinating joint action on corporate debt restructurings,
  - In such an environment of multiple equilibria/disequilibria is highly unlikely that a speedy NPLs resolution can be reached save an optimal one
  - Whereas the AMC being a focal point of entry faces none of those dilemmas and conflicting incentives

AMC obstacles in the Eurozone

- Asymmetrical legal regimes impacting in recovery rates and timeline
- Asymmetrical governance and transparency standards
- Severe market for lemons situation in some of the worst hit jurisdictions
- Inherent/existential (rather than Treaty prohibited) fear of fiscal burden sharing and debt mutualisation
- State aid ”rules” (Commission 2013 Banking Communication and the *Kotnik 2016* case) mandate burden sharing, foremostly for shareholders but also subordinated creditors (though how strong is the requirements for the latter is a matter of debate)
- The BRRD bail-in requirement

Avgouleas, Goodhart 2017 (i)

- Holding company structure/quasi-ring-fenced country-based AMCs
- Centralisation of decision-making, transparency and marketing (EZ holding company/agency)
- Aids comparability of recovery and effectiveness of country recovery regimes
- Debt platforms can be established at the centralised level
- Centralisation and objectivisation of valuations
  - EIB acts as the valuer
  - Price calculated by reference to net book value, market value, Long-Term Economic Value (weighted equally **unless proven unsound**)
  - Real life auctions held, where possible, to identify market value
  - Clear-cut and transparent distribution of losses

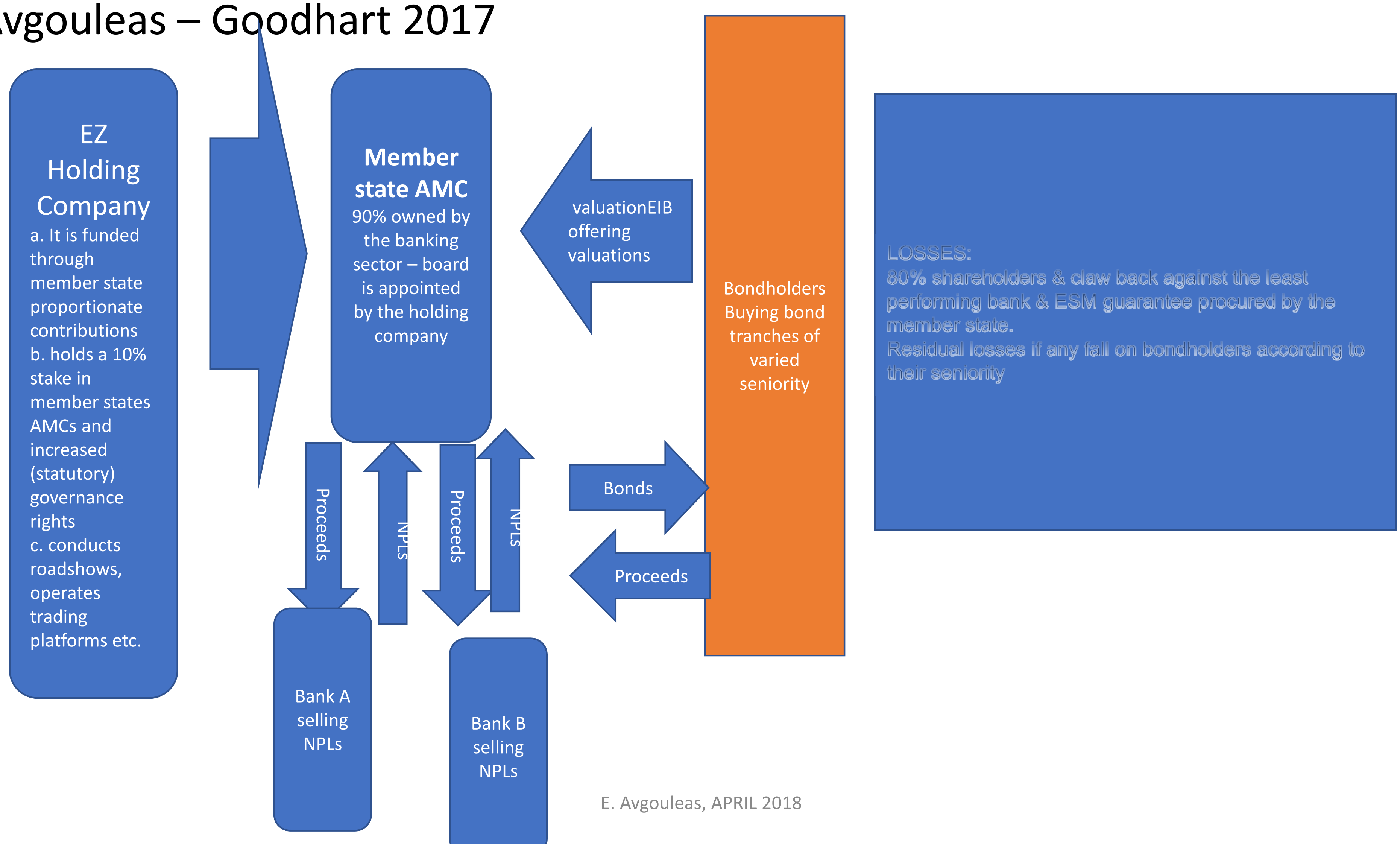
Avgouleas, Goodhart 2017 (ii)

- Decentralisation of losses/no permanent transfers/no mutualisation
- Predominantly private scheme at the member state level – bank owned scheme funded by shareholders' equity and asset backed debt
- But the ultimate guarantor of residual losses the state via the ESM precautionary recapitalisation facility in the form of a guarantee- (contingent loan/contingent credit that may or may not have to be disbursed) rather then an outright loan (instant disbursement) –
  - ESM statute change?
  - Or just an opinion issued by its board as to the legal meaning of the term loans?
- Temporary transfers via the ESM to aid financial stability legal under ECJ's ruling in *Pringle*

Avgouleas, Goodhart 2017 (iii)

- Clawback (only) for the worst offenders to battle moral hazard
- Structural conditionality a possibility
- Burden sharing ingrained in the scheme:
  - bank shareholders' lose money through the bank's participation in the scheme
  - raising new equity may be mandated
- Is it legal state aid if subordinated creditors are not hit?
  - Could CoCos be converted –
  - would require change in CoCo documentation via CACs
- It presents no fundamental discrepancies with Enria 2017 and other plans

Avgouleas – Goodhart 2017



E. Avgouleas, APRIL 2018