Europe’s Public Debt Crisis: What Will Work and What Won’t
By Juergen von Hagen

Three years after the global financial crisis hit, the euro area finds itself in a severe public debt crisis. Many euro-area member countries have piled up unsustainable levels of public debt. The countries in the most critical condition today are Greece, Portugal and Ireland, followed by Italy and Spain, but even France and Germany suffer from excessive burdens of public debt, which reduce their prospects for healthy economic growth in the medium term. The implications of rapidly ageing populations add to the bleak outlook on the sustainability of public finances in the euro area.

The reasons behind the public debt crisis vary by country. In Greece and Portugal, it is the result of a long-lasting lack of fiscal discipline, the unwillingness to cut public spending or raise sufficient taxes. Obviously, the euro area’s Stability and Growth Pact failed to impose sufficient discipline on these countries despite all of its detailed rules and reporting obligations. In contrast, Spain and Ireland managed to reduce their debt burdens significantly before the financial crisis due to relatively disciplined budgetary policies and strong economic growth. In these countries, the crisis resulted from the governments overestimating their ability to rescue failed banks. Italy, finally, presents yet another case. Although its debt-to-GDP ratio has long been very high, the country did not run very large deficits in recent years. The fiscal situation only began to deteriorate seriously when the interest rate Italy pays on its debt started to creep up as investors became leery about European public debt during the current crisis. Italy thus is a case of negative expectations leading to negative outcomes. Unless the government manages by some decisive actions to convince investors of the sustainability of its public finances, interest rates may raise to the point where the government truly becomes unable to service its debt.

In 1999, at the introduction of the euro, things looked very different. The common currency first led to the convergence of interest rates at very low levels, reflecting market expectations that inflation in the euro area would be low. Indeed, the prospect of low interest rates was one of the main attractions for many governments to adopt the euro in the first place, because it implied a significant reduction in the cost of borrowing, especially for those countries entering the monetary union with high levels of public debt. However, the developments of the past 18 months have shown that the hope for eternally low interest rates was an illusion. It lasted only until the basic premise that all government debt issued in the euro area is risk-free proved to be wrong. This is because membership in the monetary union fundamentally changes the conditions under which governments issue debt. With a national currency, a government facing a public debt crisis can turn to the central bank and order it to print money and buy up the excess debt. A sovereign default can be avoided at the price of high inflation. Investors can protect themselves against the risk of sudden high inflation by demanding an inflation risk premium in the interest rate. Greece, for example, paid about 24 percent interest on its public debt in the early 1990s.

In the monetary union, this mechanism does not work unless the common central bank stands ready to buy large amounts of debt of individual member states. To prevent that from happening was the main justification for the independence of the European Central Bank (ECB). The implication is that in a monetary union governments are more likely to default than before. High interest rates are then the result of a default risk rather than an inflation risk premium. Obviously, it took markets a few years to realize this. Now that they do, it is unlikely that interest rate spreads will go away and interest rates converge again in the foreseeable future.

The Bond Approach
Eurobonds have been proposed as a solution for this. The idea is that all euro area member states would pool their public debts and issue bonds guaranteed by all governments collectively. These bonds would then have an interest rate equal to the weighted average of the interest rates paid by the individual governments today, with weights equal to the relative quantities of Eurobonds issued by the individual governments.

However, Eurobonds pose two problems which are unsolvable in the euro area today, and which the president of the European Commission, Jose Manuel Barroso, conveniently forgot to mention in his recent Green Paper. The first is that, in order to yield the promised effect, every government would have to guarantee the total amount of Eurobonds outstanding at any point in time. Otherwise, an investor holding a Eurobond would still face a risk of losing part of his money, if an individual government becomes unable to repay its debt. Such an unlimited guarantee, however, would imply that every member state gives all other member states permission to borrow against its future tax revenues. That would be inconceivable, especially for the smaller euro-area member states, whose national public wealth could be wiped out completely if one of the larger states defaulted on even a small portion of its public debt. In practice, governments will guarantee Eurobonds only up to the amounts they have issued themselves.

The second problem is that the Eurobond solution requires that governments do not incur debt in any other way except Eurobonds. Otherwise, those with above-average ratings would simply opt out of using Eurobonds and issue other financial instruments to benefit from their better standing in the credit market. This would push up the interest rate on Eurobonds to the average of the remaining countries, until all but those with the worst credit conditions are left as issuers of Eurobonds. That, of course, would defy the whole purpose of the project. But forcing governments to borrow exclusively through Eurobonds would be practically impossible in the euro area today.

In order to solve the crisis, German Chancellor Angela Merkel and French President Nicolas...
The current problems of Ireland, Spain and even Italy show that a debt crisis can emerge even if the budgetary fiscal flows are well under control.

In practice, this would mean that the European Financial Stability Facility would exchange Greek bonds against EFSF bonds and retire the former. Over time, the other governments would pass parts of their tax revenues to the EFSF to pay interest and capital on EFSF bonds. The problem with this solution is that the EFSF’s financial capacity is limited. Bailing out Greece would absorb a large part of it and cast doubt on its ability to guarantee the debts of Portugal and Ireland. Further EFSF bailouts might become necessary, requiring an expansion of the facility’s financial volume, which would meet overwhelming political resistance in Germany and other member states.

The second possibility is a bailout by the ECB. Considering the relatively small size of the Greek economy and the country’s public debt in absolute terms, such a bailout would not have to result in much higher inflation rates in the euro area. However, setting a precedent in the Greek case, the ECB may not be able to resist political pressures in the future to do the same for other, larger countries and such bailouts could seriously threaten price stability in the euro area. This is why the ECB’s past purchases of government bonds issued by Greece, Portugal, Ireland, and Italy have met strong opposition, especially in Germany.

The third possibility is an open default by the Greek government, which would unilaterally stop servicing its debt and negotiate a cut in the value and a restructuring of its debt with its creditors. In fact, this is what should have happened earlier in the process already. One reason why it did not is presumably because the French and the German governments in particular feared the political fallout of another banking crisis caused by the losses to French and German banks holding Greek government bonds. Those concerns should by now have moved to the background as the banks have had enough time to take precautionary measures. The other reason why it did not happen may be that, at the beginning of the crisis, European policy-makers felt too uncertain about the procedure to follow in the case of a sovereign default and its likely effects. Such uncertainties should also become less relevant now, as the IMF has ample experience with sovereign default and can bring its expertise into the process. As time progresses, therefore, this third possibility is becoming increasingly likely to remain the only feasible one.

An open default would clearly restore the principle that every member state of the euro area is responsible for its own liabilities. This is, in fact, the principle intended by the “no-bailout” clause of the European Treaty. An important lesson to learn from the current crisis is that this principle is not credible unless the euro area has its own legal and procedural framework for sovereign default. Without such an institutional framework, politicians will always prefer “rescuing” a country in crisis to embarking on what they perceive to be an uncertain course of action. Therefore, a key element of the future fiscal framework of the euro area must be a sovereign default mechanism that determines who does what and provides guidelines for what to do in such cases. This would require the establishment of a euro-area court of default to which a government facing a fiscal crisis could turn to ask for a standstill of all payments on its debt and which would declare any agreement on a settlement with a sufficiently large majority of its creditors binding for all creditors. It would include guidelines for organizing negotiations between the debtor government and its creditors and it would provide for financial assistance to the government after a settlement has been reached. Such assistance would be economically justifiable, since the sustainability of the country’s public finances would be restored as a result of the process.

Creating such a framework would have large repercussions for financial markets and their regulation. National governments would admit that public debt is not risk-free and lose their privileged position in banking regulation. At the same time, the incentives would be increased for investors to monitor carefully the fiscal performance of governments, resulting in stronger market discipline. This, together with a firm commitment to the no-bailout principle, is the only basis on which the euro area will be able to survive.

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