

Life in the Eurozone: With or Without Sovereign Default

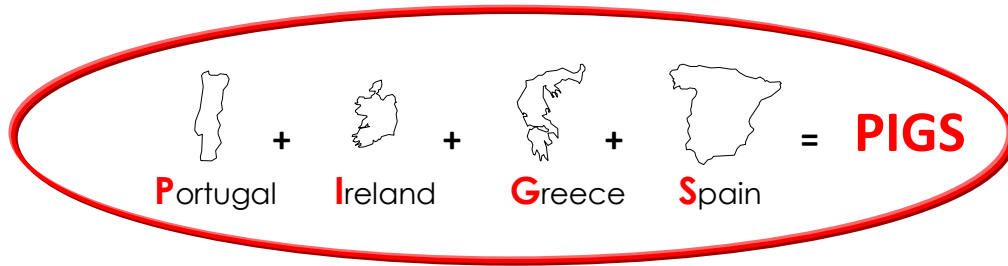
Franklin Allen
Elena Carletti
Giancarlo Corsetti

Contents

1. The Current Situation: The Euro Crisis: A Crisis of PIGS?	2
2. Life in the Eurozone With or Without Sovereign Default?	3
3. Life in the Eurozone With or Without Sovereign Default? The Current Situation.....	4
4. Ireland's Sovereign Debt Crisis	5
5. Quo Vadis, Euroland? European Monetary Union Between Crisis and Reform	6
6. Sovereign Debt and Banks: Need for a Fundamental View on the Structure of the Banking Industry	7
7. Greek Debt – The Endgame Scenarios.....	8
8. Rules-Based Restructuring and the Eurozone Crisis	9
9. The Economic Consequences of the Euro Pact	10
10. Exiting the Euro Crisis.....	11
11. Life With and Without Sovereign Defaults: Some Historical Reflections	12
12. The European Crisis: A View from the Market.....	13
13. How the EU Wants to Solve the Crisis – and Why This is Not Going to Work	14
Postscript: The EU in 2013 – Debt Defaults and More?.....	15

1. The Current Situation: The Euro Crisis: A Crisis of PIGS?

Ramon Marimon



2 Different Stories

Pre-2007/8 Crisis

Growth

Employment

	High			Vs.	Low
	Ireland	Greece	Spain		Portugal
93-'02	7.7%	2.7%	3.2%		2.7%
03-'07	5.2%	4.4%	3.5%		1.06%
07	5.6%	4.3%	3.6%		2.4%
09	-7.6%	-2%	-3.7%		-2.5%

	High		Vs.		Low	
	Portugal	Ireland			Spain	Greece
00	68.5%	65%			56.5%	56.5%
03	68%	66%			60%	59%
06	68%	68.5%			65%	61%
09	66%	61.5%			60%	61%



Balance on Current Account

	Portugal	Ireland	Greece	Spain
03	-6.5%	0%	-6.6%	-3.5%
05	-10.4%	-3.5%	-7.4%	-7.4%
08	-12.6%	-5.6%	-14.7%	-9.7%
10	-9.9%	-0.7%	-10.4%	-4.5%

5 Million Unemployed in Spain today

Over 7% drop in Ireland's employment rate. More jobs lost 07-09 than created in boom years 00-07

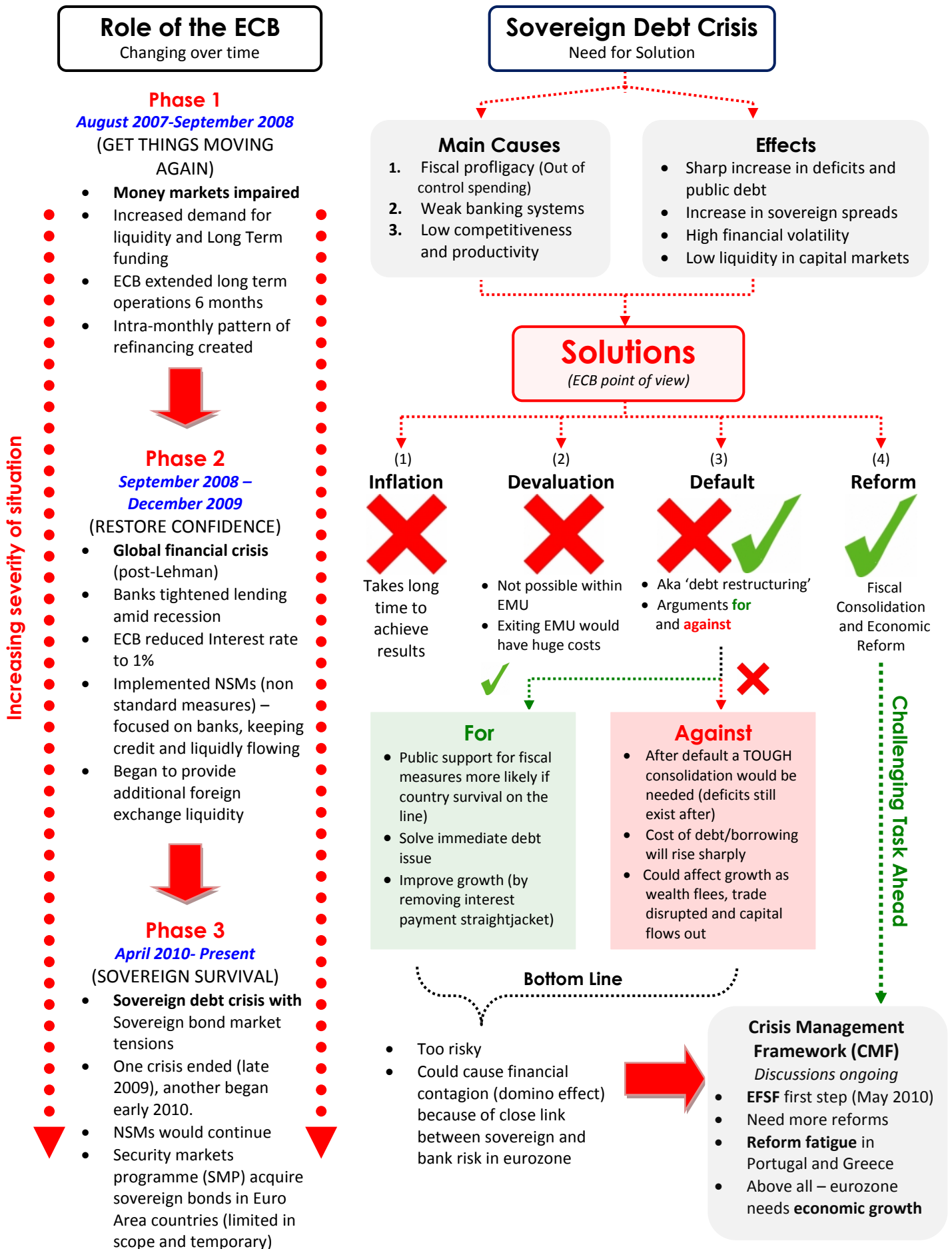


The Iberian Problem

Portugal	Spain				
<ul style="list-style-type: none"> • Not a property bubble, banking or real estate problem • Persistent low growth and productivity. Tackling with cheap credit borrowing didn't work • Brain drain - skilled colonies bound (Brazil, Angola). Needs human investment, too much focus on austerity? • Can't devalue in eurozone – increase VAT? (already high at 23%). 	<table border="0"> <tr> <td>Pros</td> <td>Cons</td> </tr> <tr> <td> <ol style="list-style-type: none"> 1. Better situation than Portugal – high growth volatility, could spring back fast 2. Big banks learned from Latin American experience 3. Strong capacity to export and offer quality services </td> <td> <ol style="list-style-type: none"> 1. The Spanish dual economy (traditional V. advanced sectors) 2. 'Lost generation' – many long term unemployed and PT 3. Immigration problems 4. Low skilled workforce 5. No regional budget coordination 6. Weak entrepreneurial sector (productivity problems) </td> </tr> </table>	Pros	Cons	<ol style="list-style-type: none"> 1. Better situation than Portugal – high growth volatility, could spring back fast 2. Big banks learned from Latin American experience 3. Strong capacity to export and offer quality services 	<ol style="list-style-type: none"> 1. The Spanish dual economy (traditional V. advanced sectors) 2. 'Lost generation' – many long term unemployed and PT 3. Immigration problems 4. Low skilled workforce 5. No regional budget coordination 6. Weak entrepreneurial sector (productivity problems)
Pros	Cons				
<ol style="list-style-type: none"> 1. Better situation than Portugal – high growth volatility, could spring back fast 2. Big banks learned from Latin American experience 3. Strong capacity to export and offer quality services 	<ol style="list-style-type: none"> 1. The Spanish dual economy (traditional V. advanced sectors) 2. 'Lost generation' – many long term unemployed and PT 3. Immigration problems 4. Low skilled workforce 5. No regional budget coordination 6. Weak entrepreneurial sector (productivity problems) 				

2. Life in the Eurozone With or Without Sovereign Default?

Fabio Panetta



3. Life in the Eurozone With or Without Sovereign Default? The Current Situation

Helmut Siekmann

Some early facts

1. Crisis is one of **financial institutions**, mainly by big banks
2. **Banks and other financial institutions** irresponsible lending
3. Crisis is of **sovereign states** and government with unsustainable debt mountains
4. Crisis affects **ECB** as risks of sovereign debt transferred from market to central banks ('socialisation' of debt)

Crisis of banks which lent too much without charging a risk adjusted price (appropriate interest rate)

Not a € issue

- ECB cannot lend money to the EU
- No stringent link between fiscal problems and currency uses

(TFEU Article 123)

Supervision

Failure of financial markets and economic sciences

+ failure of supervision rules

= crisis!

Lack of Obedience

EU states not adhering to legal norms and contracts

Sovereign Default



Definition

- a) Gov entity (public body) is not willing/able to fulfil its financial obligations properly (undefined)
- b) Legal procedure to resolve insolvency/illiquidity issues

Insolvency and Law

- Basic society principle of 'pacta sunt servanda' = demand of justice but also economic efficiency
- Orderly distribution of assets of a entity then dissolved at the end of the procedure

Insolvency of Gov Entity

- Gov entities cannot be dissolved
 - Legal obligations: All EU-27 'shall avoid excessive government deficits'
- (TFEU Article 126)

Role of Creditors

- Greek bailout = bailout of French, Spanish and German banks & creditors
- Southern European debt now held by German state banks and institutions of European System of Central Banks (ESCB)



Prevention (Now)

- EU law focused on **prevention** not crisis resolution
- **Result: Ad hoc ex-treaty** measures (EFSM, EFSF)

Prevention (Post-2013)

Fiscal Discipline

Primary Law

Maastricht Criteria in TFEU (Lisbon Treaty)

- 3% budget deficit 60% Debt: GDP ratio
- No sanctions – no 'eviction' mechanism
- Avoided fiscal equalisation mechanism

Secondary Law

Stability and Growth Pact (SGP)

- 1997 Original with automatic sanctions
- 2005 Amendments reduced strictness
- 2010 5 point reform plan

Lack of Common Fiscal Policy?

- No real need in theory
- US doesn't have one nor Germany (until 2009) – US trades grant aid with 'strings attached' for indirect influence
- German Lander are not legally forced to avoid 'excessive deficits' in order to fulfil Germany's obligations toward the EU!!

Rules for Aid

"...by natural disasters or **exceptional occurrences** beyond its control"

(TFEU Article 122)

No ECB financing of the public sector but 'indirect' purchase of govt bonds via ESCB since summer 2010 EU or members *cannot* 'assume the commitments' of others

(TFEU Article 125)

Voluntary Bilateral support? Yes!
Germany worried about constitutional issues re: their law and Landers

Temporary Support Mechanisms

EFSM (EU) = €60bn
EFSF (€zone) = €440bn
IMF (Credits) = €250bn

Mostly guarantees not direct payments backed by AAA ratings (in only 6 EZ countries)

'where a member state is in difficulties...caused by natural disasters of exceptional occurrences beyond its control... Council...may grant financial assistance'

(TFEU 122 para 2)

Permanent Support Mechanism

ECB now exposed

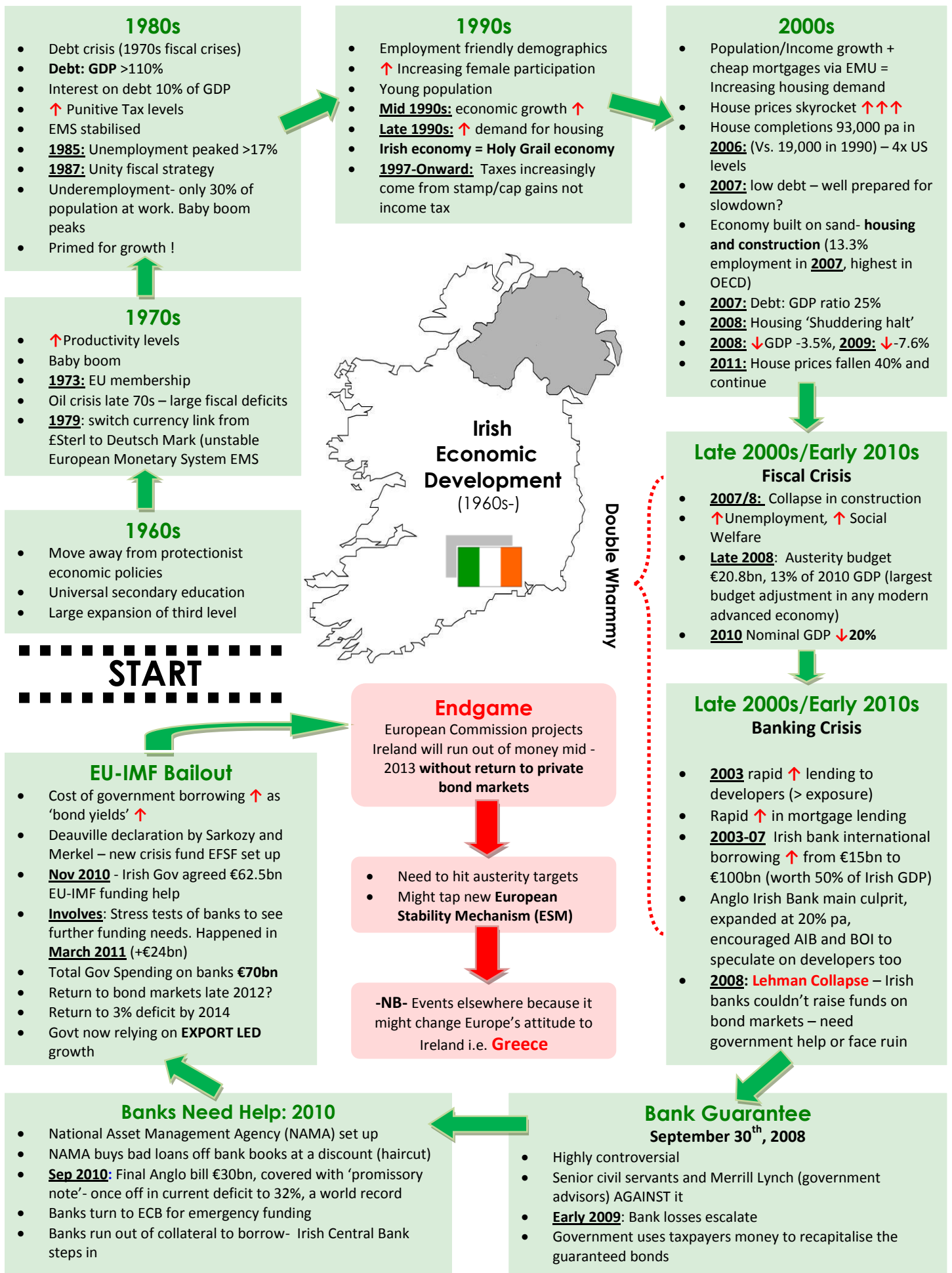
Holds a big share of sovereign debt

ESM agreed 17 Dec, 2010
(TFEU Article 136)

A support mechanism set up by member states **outside current Union institutions** could conform with German and EU law

4. Ireland's Sovereign Debt Crisis

Karl Whelan



5. Quo Vadis, Euroland? European Monetary Union Between Crisis and Reform

Martin Hellwig

Changing ECB

- Modeled on Bundesbank policy of **strict price stability**
- 2011**: Pressure to print € to pay for deficits
- Erosion in this 'stability culture' thanks to EMU (€ safeguards in SGP and Maastricht weak)

Why?

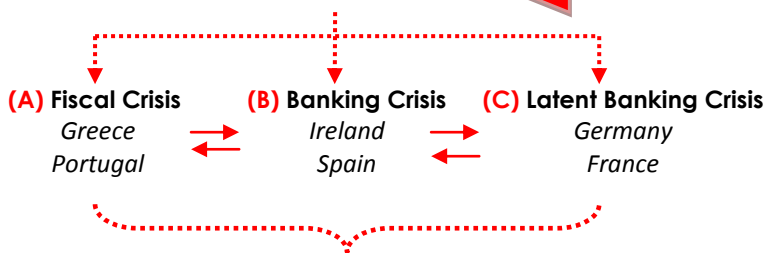
- EMU depoliticized monetary policy (made it supranational)
- ↓ importance of exchange rate in Europe
- E. Commission power ↑, encroach on ECB
- Lack of SGP credibility but EMU needs strong governance requiring a treaty change (which will be v. political)
- Unnatural tension as national authorities still supervise banks – lack of coordination between central banks (last resort lenders) and govts

ECB Hallmarks

Depoliticisation

Professionalisation

3 Crises



Need to **protect** Northern European banks (aka creditors, bondholders)

So, why is the Current Crisis so Difficult to handle?

- EU needs workable strong governance mechanisms
- Fragile bank balance sheets in Northern Europe = exposure to sovereign debt from Southern Europe and bank debt from Ireland and Spain.
- To solve (A), requires a prevention of (C) (Deauville) - but country has to be insolvent
- No country wants to admit this – proof of it from history (Weimar Germany 1930s, Latin America 1980s) if conditions met – **country can't...**
 - Collect taxes from elites
 - Sell state assets
 - Cut public salaries

Current Discussion: What about EU Solidarity?

- In fairness, Germany sacrificed growth and investment to bring in EMU
- Different sovereign borrowers (countries) have different fiscal capacities = an anomaly**
- Without EMU, PIGS **would not have been able** to borrow at low IRs
 - Border solidarity weak**: suspicions and lack of transparency over who is being supported (German bankers Vs. Greece public employee debate)
 - This is **NOT** a currency crisis - purchasing power of the euro is not affected (forget what media, politicians are saying)
 - Huge need** for an EU governance system post-2013

Underlying Issues

- Common currency ≠ Common price system. **Prices volatile**
- = EU markets not integrated
- Varying inflation (much higher than US states, Swiss cantons or German lander)
- Exchange rate reflects this but fixed in EMU
- IR should reflect risk – it didn't (common IR via ECB)
- Lack of fiscal discipline by lenders, borrowers and gov

Without EMU Greece/Portugal would have been okay?

Without EMU

No, they wouldn't!

- Couldn't have borrowed in the first place
- May have borrowed in foreign currency
- In crisis, they would have devalued – inflating their debt priced in their home currencies (but tradable exporting industry would be made more competitive)
- 'Original sin' - inability to borrow freely in ones own currency b/c risks inherent in foreign currency borrowing

Recommendations

New fiscal governance mechanism must be sensitive to countries banking system

- Ireland, Spain – not arisen due to fiscal policies, more from unsound banking practice + TBTF approach by gov
- SGP says Ireland, Spain doing well – never appeared on radar of SGP. Big problem.

Make bank supervisors independent

- Move away from banks seen as source of gov funds (savings)

Strengthen EU supervisory institutions

- Irish case has repercussions
- If costs of bank bail outs are really born by all EU taxpayers then banking supervision should be at supranational level
- Keep banking supervision and MP away (not under same roof – lessons from US experience)
- Reduce moral hazard issues – no ECB bailouts (discipline institutions)

6. Sovereign Debt and Banks: Need for a Fundamental View on the Structure of the Banking Industry

Arnoud W.A. Boot

Current Crisis Lessons

- Fragility of banks and financial sector
- **Now (2011):** Sovereign Debt Crisis
- Debt Restructuring will hit bank balance sheets (govt help)

Current Problems

- No EU burden sharing/crisis procedures re: supervision of banks
- **De Larosiere Report (2008)** aimed at tackling issue of bank supervision
- Still under national control

Dealing with size and complexity

Breaking up banks and living wills

In other industries, the market can decide the optimal size of firms. **Banking is different...**

- Its very complex, difficult to manage
- Huge interconnectivity reduces info breeds idea of 'Too Big To Fail' (TBTF)
- Supervision/Regulation is therefore tricky

Current Reforms: 'Living Will' each institution must produce detailed recovery and resolution plans. Drive to reorganise to resolve complexity

Best way to do this? Break up into subsidiaries? **New Zealand model**

New Zealand model

- Banking system foreign owned
- Authorities instituted structural requirements to assert control
- Enforced subsidiaries, making them independent, keep risks low
- Model for EU-27?

2 Solutions to change bank organisation

Breaking up Banks?

- Many UK advocates inclu. Mervyn King (BoE Governor), Adair Turner (Chairman of FSA)
- UK Independent (Vickers) Banking Commission shied away from it

Complexity makes supervision very slow.
Breaking up best?

2 lessons via financial crisis

- 1) **Contagion** should be addressed
- 2) Core commercial banking functions might have to be **safeguarded**

If a break-up increases transparency and reduces complexity, solve these

A B

Can Separate Legal structures under one corporate roof be effective?

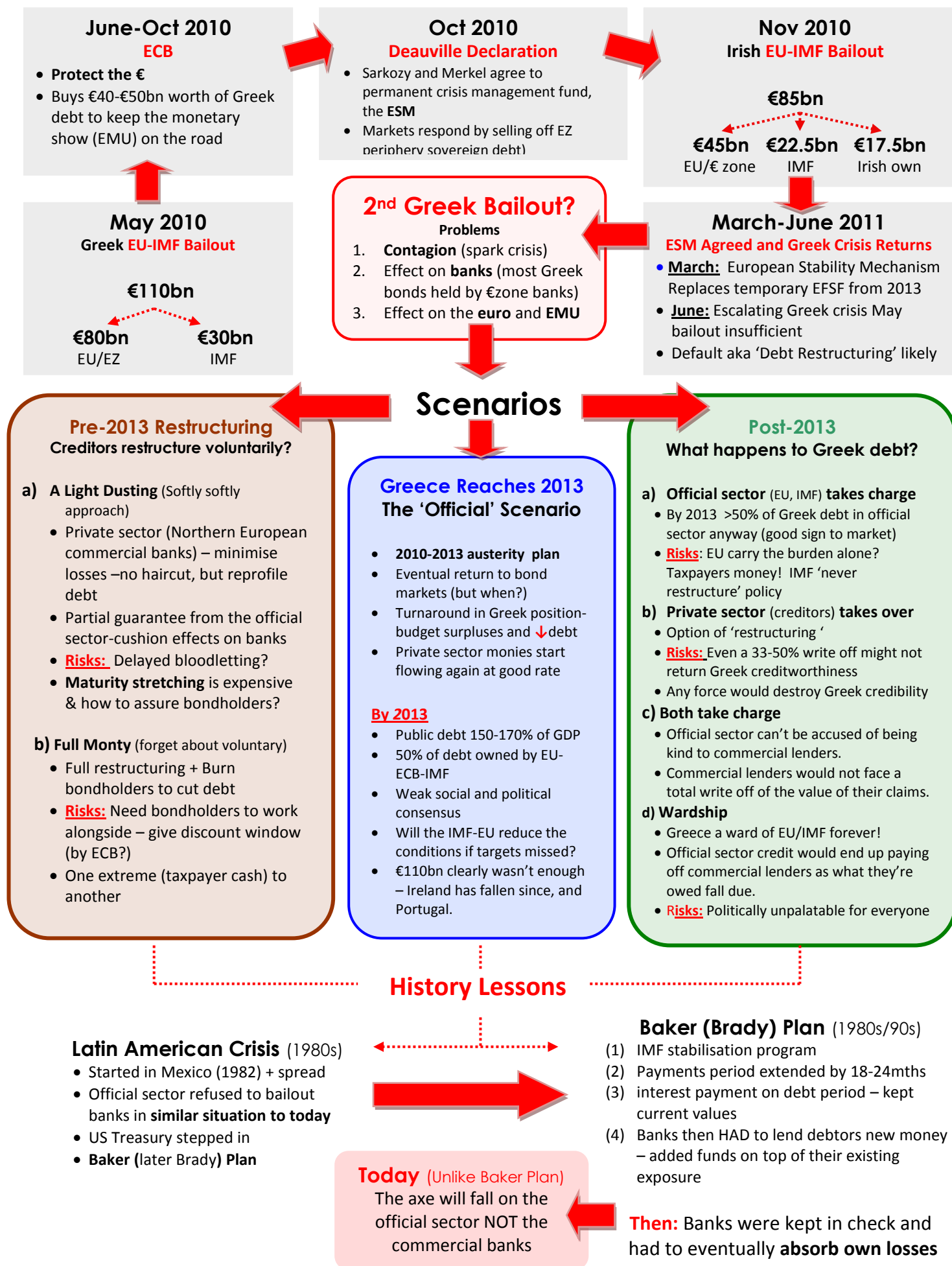
- Unclear but most do i.e. HSBC with 2,000 entities
- Main purpose: not ↓ complexity and ↑ transparency, just to economize on taxes or for regulatory arbitrage
- Still linked in many ways : offices, shared facilities, activities
- Potential conflicts still enormous
- Industry will oppose any action that would limit synergies – they like complexity and hold supervisors hostage

In Summary

1. Banks very complex
2. Hard for regulators to grasp linkages
3. **NO** well established solutions

7. Greek Debt – The Endgame Scenarios

Lee C. Buchheit & Mitu Gulati



8. Rules-Based Restructuring and the Eurozone Crisis

David A. Skeel, Jr.

Current Eurozone Crisis = 'déjà vu all over again' only closer to home

A Lesson from the Great Recession

Summary: Need a credible, specific alternative to bail-outs or the market will expect more and (self fulfilling prophecy) will cause more

- Post-Argentinean default (2002), expectations for a wholesale reappraisal but IMF funding was limited.
- Kept ad hoc system and added a 'collective action' provision via bonds. Still a need for more **rules based, bankruptcy-like solution.**
- No lessons learned – Europe in same place
- Markets didn't believe US gov bail-out of Bear Sterns (March 2008) was the last one. Markets expected Lehman Bros to be bailed out (Sep 2008)

A New Framework: A Model for Sovereign Bankruptcy

Summary: Proposal for a 'First in Time' Priority Payment (Bankruptcy) scheme for creditors

- Bailouts mightn't be enough (very limited)
- **New idea:** Sovereign debtors (countries in trouble) would have their creditors divided in 2 classes
- Voting process for restructuring – country would submit proposal on haircut, a majority of creditors must vote and agree (class by class vote)

Is the Eurozone Different?

Summary: Portugal, Ireland and Greece (PIG) cannot devalue so bankruptcy procedure is a good option and would fit well into the EMU/EU structure

- Bankruptcy style schemes criticised for creating moral hazard for debtors (countries) – default is tempting as in Argentina (2002)
- Would it work for Europe?
- Greece/Ireland depend on eurozone financing
- An EU-scheme would be less intrusive as eurozone already supranationally controls monetary policy
- PIGs are all in EMU, cant devalue – bankruptcy a good alternative

Implications for European Banks

Summary: As European banks will be affected by default/restructuring/bankruptcy, the countries where these banks are situated should take action

- Biggest concern with the bankruptcy scheme or any restructuring = effect on European banks (which hold a high % of sovereign debt from Southern Europe – potential defaulters)
- **More sense:** Countries where these banks are (Germany, UK, Belgium) to decide to intervene in case of destabilisation following a default.

Who Would Oversee the Process?

Summary: Single judge procedure in an EU country other than the countries own (ideally where the creditor banks and a decent amount of debt is based)

- Most proposals see the IMF or international organisation controlling the process
- Author proposes ordinary bankruptcy process/insolvency judges
- Not ideal for eurozone
- Effectiveness of a single judge for this? Lessons from US and Canada over Chrysler and General Motors
- Panel of 3 European judges?

9. The Economic Consequences of the Euro Pact

Edmond Alphadéry

Wrong Assumptions



Countries Can Leave?

- Members cannot simply go back to national currencies if they leave
- As likely to happen as Texas or California leaving the US\$
- Enormous damage to country if they leave, need capital controls
- Damaged members forced to leave EU

Eurozone Breakup?

- Likelihood of breakdown small
- Eurozone is not an optimal currency area
- Would only collapse with systemic shock bigger than Lehman Bros
- **Greek default?**



Lessons from History

- German reparations post WW1 (punishment which lead to the Nazi rise and WW2)
- Keynes 1919 book 'economic consequences of peace'
- 'If Germany is to be milked, she must not first of all be ruined'
- Point: **Solidarity** needs **sustainability**

European Focus

Solidarity + Sustainability

New European Framework

- March 25, 2011 – European Council meeting
- Comprehensive framework for permanent (financial) crisis prevention (ESM) post-2013
- If one jeopardising the European financial sector (unsustainable budget deficits etc) – **time for action**

II- ESM Implementation (June 2013)

- ESM fund = €500bn (from EU and IMF)
- Will only giving funding after **sustainability analysis**

ESM Funding will help

- No *burning bondholders* (i.e. Northern European banks, main creditors, don't lose)
- Country will get *good/low interest rate*

ESM Funding wont help

- Must *negotiate* on their own with creditors (bondholders)
- Get *agreement* and a *plan* with private sector
- THEN they can get funding

I- Responses to the €zone Crisis

- Maastricht (EZ birth treaty) **no** detail for crises
- Cost for the non-EU intervention = Banking/Financial sector bankruptcy + EU image hit
- Why not intervene? Moral hazard
- So, EU must intervene closer to bankruptcy (time a factor), expected cost/benefit of non-intervention nullifies

Europe has intervened 4 times

1. **May 2010:** Greece (EFSM) later expanded EFSF
2. **Oct 2010:** Deauville declaration (permanent fund to be set up by 2013) + Collective Action Clauses to mitigate moral hazard. Irish bailout Nov 2010
3. **March 2011:** Euro Council adopts Euro pact – lowers Greek IR to 4.2% (reschedule loans to 2021)
4. **April 2011:** Portugal bailout

III- Reduce Pressure on June 2013

2 real options in June 2013

a) Screw 'em

- PIGS on unsustainable path
- No ESM funding
- Let them **DEFAULT!**

b) Help 'em more

- Done with stabilising debt
- Give them ESM loans with conditionality

- a) or b) not ideal options
- **Best option** Countries financing themselves via the market again

Author models predict

(if a country follows...)

1. **ESM borrowing** (PIG *stabilise* debt by 2017)
2. **Market borrowing** @10% interest (*Nearly stabilise* by 2017)

Moral: Portugal, Ireland and Greece need help with overall debt burdens via programmes to reduce debt i.e. privatisation, improved EU loan terms etc

10. Exiting the Euro Crisis

Charles W. Calomiris

Eurozone Problems

Banking Insolvency

Fiscal Unsustainability

Why the euro won't last

Realities of the eurozone

Over-Indebtedness

- Excessive
- Need to address via default/restructuring
- Inevitable

High Deficits

Post-default/Restructuring

- Hard to fund your deficits
- High deficit country must leave the € to print money
- OR**
- Get public sector support for deficit borrowing (difficult)

Non-Competitiveness

1. Over valued exchange rates
2. Poor productivity (exports)
3. Rigid labour markets

Solutions

- Protracted recession and austerity
- Leave € and start again

Lost Causes? Greece, Portugal

- Greek debt and deficits unsustainable
- Austerity plans not enough
- Main problem: Overvalued exchange rate
- Greece needs a transfer (NOT A LOAN) of €200bn+
- **Conclusion:** Leave EZ and rejoin later after reforms take place to their fiscal affairs, labour markets and pension systems

Recovery Possible Ireland, Spain

- Ireland and Spain need to avoid assume full private bank debts (German, British, Danish, Belgian etc) i.e. they need to burn bondholders
- If they can, they'll be sustainable
- More realistic possibility of improvement in these than Greece, Portugal in short/medium term



What Should Happen

Europe does the following:

- Encourage policy adjustments for the PIGS
- Agree to loss sharing arrangements to absorb losses in an orderly way

What Will Happen

Europe does the following

- Builds Chaos
- Engages in Ad hoc and poorly coordinated emergency measures taken in response to bank runs
- Doesn't convince depositors and causes run on Greece

I- The Numbers Say So

- Sovereign default/debt restructuring seems and resulting departure from eurozone inevitable

II- The Theory Says so

- Real exchange rate theory and political economy
- Americans far more pessimistic about the euro, Europeans in denial?

Author in 1999 suggested that eventually...

- **At worst:** Eurozone would break up
- **At best:** Need € depreciation to keep it together
- Southern Europe would become fiscally unsustainable, bank losses = bank insolvencies + fiscal pressure on governments via bank bailouts

Consequences of € launch predictable

- 1) Eurozone not an optimal currency area (OCA)
- 2) Economic inconsistencies among members
- 3) Political differences likely to arise

Author in 1999 predicated this scenario

- a) Southern Europe has low productivity growth (in tradable goods) = Productivity gap
- b) Reinforced by existing labour, human capital and trade issues
- c) 1997 East Asian crisis - Harrod-Balassa-Samuelsen theory of real exchange rate - *if 2 countries with productivity growth differences in their tradable goods adopt a common currency eventually the slow prod country will have recession (will need price deflation or devalue currency)*
- d) East Asian economies buffering declining profits from trade (as competitiveness fell) with credit
- e) **Choices:** Slow Growth V. Devaluation **OR** fiscal stimulus **OR** facilitate (via easy bank credit) the growth of non-tradables i.e. housing
- f) Say ECB forms EMU, lower IR on debt + already low tradables productivity – more buffering via fiscal binge!

PIGS (and Italy) all did this

III- History Says so

- **1862 US** - departure from the gold standard (to fund civil war) meaning dollar backed by 'Greenback' not gold or silver
- **1933 US** - Gov banned gold clauses in private debt (not just public debt) contracts – protect those in trouble, could survive double blow of weak economy and depreciated dollar
- **2002 Argentina** - Left dollar standard and redenominated \$ denominated and indexed contracts into the newly depreciated peso

11. Life With and Without Sovereign Defaults: Some Historical Reflections

Youssef Cassis

3 Important Questions to Ask

Are Crises more likely in Developing or Developed Economies?

Answer: Since late 1800s most financial/debt crises have occurred in *developing* countries (i.e. 1982 Latin America debt crisis)

- **Today:** threat of defaults in *developed* advanced European economies
- Since Great Depression, banking crises in *developed* economies rare
- Crisis today like a 19th century default by *peripheral* European countries
- **Key Difference:** EMU is a unique historical experience i.e. single currency of a group of politically independent countries

Are Sovereign Default Crises more likely in Different Exchange Rate Regimes?

Answer: Sovereign defaults more common under *flexible* exchange rate regimes

- EMU = *fixed* rate regime
- Defaults were more frequent before 1914 – classic age of the gold standard – carried less risk
- Peripheral countries could ‘Opt in- Opt out’ of the gold standard as they wanted – Argentina left in 1876 but back in 1883, left again 1885 back in 1899
- Monetary unions existed before 1914 i.e. Latin Monetary Union between France, Belgium, Italy and Switzerland (based on agreeing common rate on silver contact in low denomination coins)

Have Sovereign Debt Crises in Peripheral Countries Caused Knock-on Global Financial Crises?

Answer: Very rarely! Most common examples were limited to countries/regions
 a) 1820s/1870s Latin American debt crises
 b) 1876 Ottoman debt crisis (which led to the west fiddling with Ottoman finances).
 c) 1918 Russian default (but did weaken France's financial position after WW1)

Between 1890 and 1990 only **2 sovereign debt crises** could have caused a knock-on effect

International Debt Crisis (1982)

- International capital movements dominated by loans from commercial banks to the 3rd world
- Fed by depositors from oil-exporting countries i.e. ‘petrodollars’
- Oil Income rocketed after oil crises of 73 and 78
- Panic in 82 – Mexico declared 3 month moratorium on debt payment
- American banks seriously exposed (thus the system)
- Crisis averted when agreement reached between banks and IMF

Baring Crisis (1890)

- Baring Brothers 1 of 2 biggest banks in London
- Bank overcommitted on loans to Argentina
- Could have collapsed following a default there
- Would have brought down other investment banks
- London banking community saved it – under orders from the Bank of England – crisis averted

World Periods of Global Finance

(1n Period 1890-1982)

Bretton Woods (1945-1970)

Stable era

- Very few financial crises

Interwar Years (1918-1939)

Very unstable era

- Many financial crises
- Last time an industrial power defaulted (Germany in 1933, downfall on Weimar Republic, Rise of Nazis)

Why Unstable? (Before WW2)

- Pre-WW1 Sovereign defaults had limited global impact
- Until 1918: Biggest borrowers = US, Canada and Russia
- Foreign government bonds held by **huge number of individual investors** NOT **large multinational financial institutions** (no coordination, lack of communication)
- Banks = Intermediaries – so, rarely threatened
- Post-WW1/2 globalisation, growth of unregulated finance, rise of large financial institutions.

12. The European Crisis: A View from the Market

Erik F. Nielsen

Different Market Views of the Crisis

(1) Anglo-Saxon View

- Majority of US/UK based investors overestimated and equated crisis to end of EZ so they sold off €
- Europe stood firm, this view faded.
- € strengthened as bail-outs were announced

Causes 5 factors

1. Era of 'cheap money' - World Interest rates kept too low for too long in a period of 'cheap money' (as in EMU) fuelled housing booms, erosion of productivity, increase size of public sector + rising labour costs
2. Credit rating agencies didn't understand the periphery imbalances and their actual creditworthiness
3. Insufficient regulation and supervision
4. Lack of risk management processes
5. Lack of official statistics

(2) G-7 Investor View

- Underestimated severity of the fiscal crises.
- EM Investors saw the severity but underestimated the efforts the ECB would take

(3) Real Money Investors Vs. Hedge Fund investors Views

- 'Real Money' focus on credit rating agencies (who realised the crisis late).
- Only as the crisis began to speed along did they begin to hedge

What Happened?

Past excesses + lack of reforms in a new globalised world

Policy Responses

- ECB/EU and key government reaction very good, considering trying to avoid a 'European Lehman Brothers'
- Impressive reforms in Greece, Ireland and Spain
- **One concern:** New 'quasi-fiscal' role of ECB – can't always act like a 'European IMF' by buying sovereign debt in secondary markets.
- National Central Banks should be left to do this

Good Shape

The EZ-17 economy as a whole, is healthy with 2/3 untouched (with a flexible competitive market)

Main Problems to Solve

- EU **Fiscal federalism?** Politically impossible for now and economically, not desirable (experience)
- Loans in exchange for debt service relief has better outcomes (policy reform)
- EZ polices need to be better coordinated but by domestic economies - Controlled restructuring/bankruptcy procedure needed
- Sovereign credits with vastly different fundamentals should not be treated the same

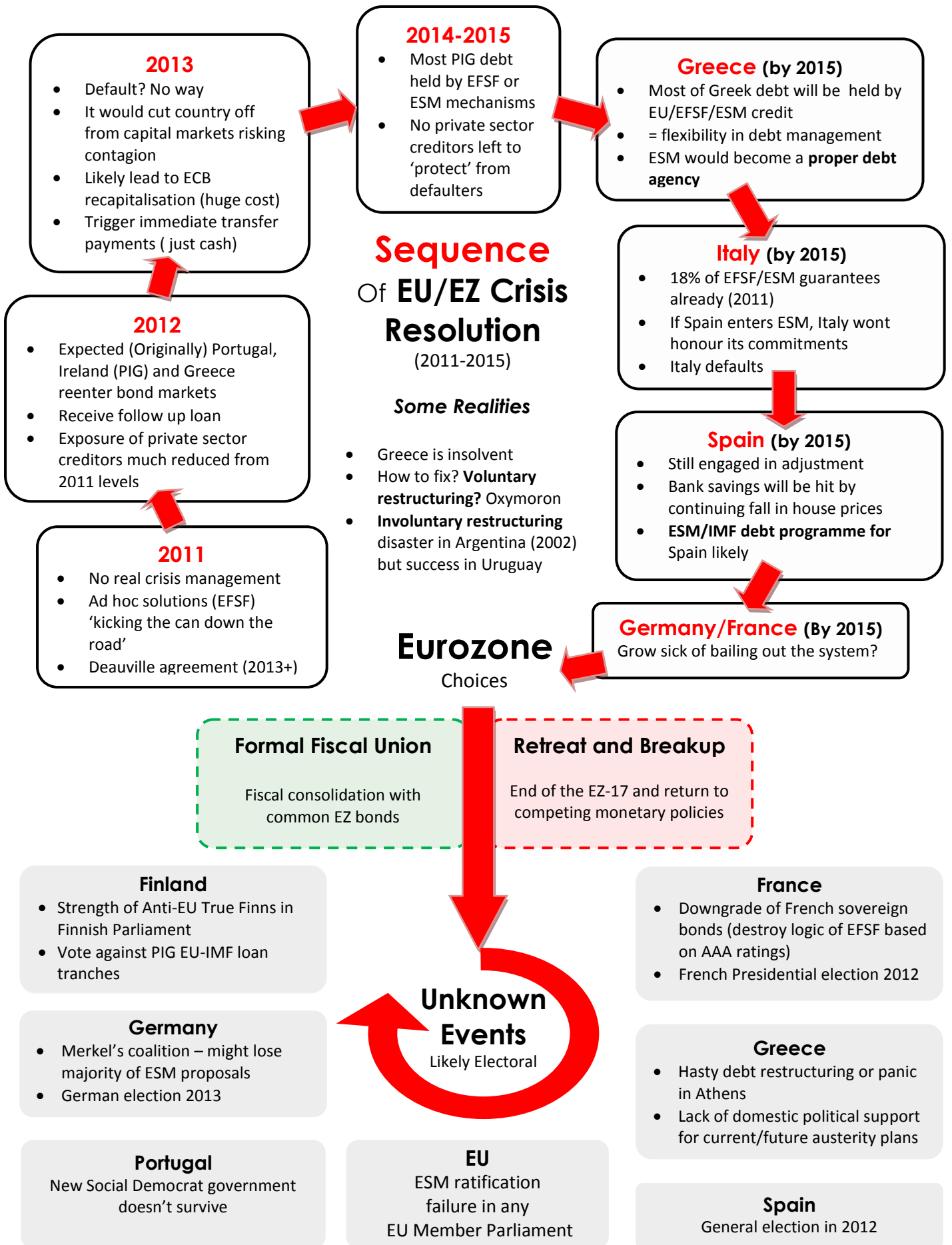
Verdict?

Fine tuning needed not a major overhaul

Moral Hazard
A market based economy will not allocate capital efficiently unless **lenders know that money can be lost!** (This guides the price of loans)

13. How the EU Wants to Solve the Crisis – and Why This is Not Going to Work

Wolfgang Munchau



Postscript: The EU in 2013 – Debt Defaults and More?

Janet Kersnar

Greece in 2013

Official 'Happy Every After' Version

- EU political machine working at this
- No Greek default
- End to financial crises
- End to banking crises

Likely Version

- Another Greek bailout likely (as the likelihood of potential default increases) (See: **Skeel** article)
- Greek Default very likely (feeling of panic receding already)

Why Unlikely?

Why Likely?

Expected Greek Problems

Debt

- Greek Debt: GDP ratio expected to hit 150-170% by 2012 (nearly triple Maastricht guideline for euro entry)
- 50% will be owned by 'official sector' (EU/ECB/IMF) – so they will decide on haircuts (See: **Buchheit** article)
- Total debt: expected €340bn- need writing off or rescheduling payments (See: **Allen** article)
- Cost: 5-10% of Greek GDP on interest payments alone + austerity

Reality

This crisis is...

A Debt problem + A Banking problem

Greece needs money or else it will need to leave EZ – they need to print money

Moral Hazard

To avoid moral hazard, need a EZ/EU bankruptcy framework – rules based and a 'first in time' priority system for bondholders/creditors

(See: **Skeel** article)

Solidarity or Bust?

- Eurozone (EZ) is doomed (See: **Calomiris** article)
- Need to make debt restructuring quicker by forcing minority bondholders to accept will of majority.
- But...the main issue is return to normal economic conditions for Greece (See: **Carletti** article)
 1. Quick default
 2. Exit from EZ – defaulting gov would regain monetary policy, guarantee the banking system, inflation and boost exports

Lessons from History

- Many lessons from the past, 60 sovereign defaults recent years (See: **Buchheit** article)
- **Argentina** (2002) is the 'poster child on how a restructuring can be terrible and costly' (\$95bn debt)
- Still struggling to return to international financial markets (See: **Gulati** article)
- **Uruguay** (2003) 'reprofiled' external bonds by extending the maturity of bonds by 5 years – no haircut – back in capital markets in 31 days. Different situation. (See: **Buchheit, Allen** articles)

31 Days (Uruguay) Vs. 10 Years+ (Argentina)

In Greece's Favour

- Greece is set up to restructure/ default in an orderly way
- Better name: **Buchheits** 'voluntary liability transaction management'?
- 90% of debt under local law
- Haircut of 50% possible
- Politicians, creditors or taxpayers – all are now in this together