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EUROPEAN SOVEREIGN DEBT: POLICY ACTIONS MIGHT BE INSUFFICIENT TO AVERT DEBT RESTRUCTURING

HIGHLIGHTS

- **European leaders recently agreed to implement several policy measures aimed to contain risks sparked by Greece's sovereign debt difficulties**
- **However, those policy measures do not solve the underlying fiscal and structural imbalances which are the cause for fiscal unsustainability in the longer term**
- **Even though the European Stabilization Mechanism has the potential to significantly reduce the likelihood of a sovereign default in the near term, from a longer term perspective, a managed debt restructuring process seems inevitable for some of these countries**

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European leaders recently agreed to implement several policy measures aimed to contain the risks sparked by Greece's sovereign debt difficulties. Although we believe these measures will be effective over the next 1-2 years in averting severe financial disruptions, the underlying macroeconomic imbalances will continue to pose solvency risks in the medium term. Addressing those imbalances will be extremely painful for some countries. Even if progress is made with fiscal consolidation efforts, we still believe debt restructuring might be unavoidable for some of the eurozone members. Simply put, they have reached a point in which debt arithmetic will relentlessly play against them for a very long period, regardless of their efforts.

Outline of the European Policy Package

On May 9th European authorities presented a set of policy actions to address the financial market jitters caused by Greece's sovereign debt difficulties which took place during the previous week. An existing loan arrangement has been augmented by EUR60 billion (to a total of EUR110 billion) on terms and conditions similar to those of the IMF for as long as needed to safeguard financial stability. In addition, member states agreed to guarantee a credit facility for up to EUR440 billion for a period of three years which will buy sovereign debt in the event European countries have difficulty financing their fiscal needs through debt markets. These two measures combined are being referred to as the European Stabilization Mechanism (ESM). The IMF will also participate in financing arrangements and is expected to provide at least an additional EUR220 billions through its usual facilities.

On May 12th the European Commission provided a framework for the conditions attached to ESM loans, while at the same time outlining an initiative to reinforce compliance with the Stability and Growth Pact, introducing broader surveillance of eurozone macroeconomic and competitive developments, and setting up a robust framework for crisis management. The first pillar is the establishment of a "European Semester", i.e. a period in which member states will submit their national budgets and reform programs for scrutiny by their peers and European Commission authorities before they are enacted by national parliaments (this is expected to begin in 2011). The second is the expansion of the Excessive Deficit Procedure to contemplate corrective actions not only for member states with fiscal deficits in excess of 3% of GDP, but also for those with debt ratios in excess of 60% of GDP. Third will be to strengthen Eurostat's mandate to audit national statistics, which will improve the quality of reporting on public finances. Finally, there is the proposal to establish a permanent crisis resolution mechanism anchored in strict conditionality and interest rates that create incentives for troubled member states to return to market-based financing while ensuring the effectiveness of the financial support. These proposals intend to correct some of the institutional weaknesses which created fertile ground for macroeconomic imbalances that ultimately led to the current crisis. Congruently, the pillars described above will provide the frame for the "strict conditionality" attached to the ESM loans.

For its part, the European Central Bank (ECB) has also pledged to provide liquidity support through three main channels. First, it will conduct interventions in the euro area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are dysfunctional. Second, it will conduct fixed-rate full allotment tenders in the regular 3-month longer-term refinancing operations (LTROs) and a 6-month LTRO with full allotment. Third, it has reactivated, in coordination with other central banks, temporary liquidity swap lines with the Federal Reserve, and resumed US dollar liquidity-providing operations at terms of 7 and 84 days.

Financial markets will need more convincing

In the near term, provided the constitutional approval requirements are cleared at each individual member level, the ESM will reduce sovereign debt default risks, and as such can be regarded as a very positive development. Nonetheless, some caution should be exercised in evaluating the effectiveness of this facility to act as a backstop for debt-overwhelmed eurozone members. Most European Union (EU) countries, including the largest ones, are not only running high deficits but also face longer term structural pressures on their fiscal accounts (as has been illustrated in our April 29th report, "European Sovereign Debt: The Beginning of a Long Journey Down a Slippery Road", available at www.td.com/economics). Thus, it is natural to question the credibility of these sovereigns to act as guarantors for the future debt to be issued, and this is something that has not escaped investors' attention. Put it in other words, how reassuring is it to have the guaranty of a group of countries if all of them are heavily debt laden?

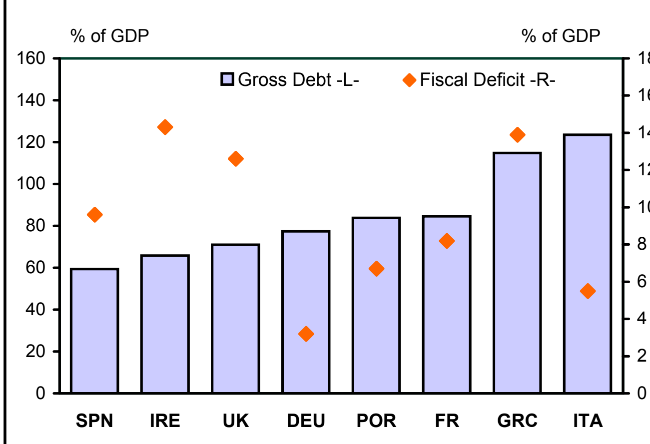
Furthermore, the fine print defining crucial details such as the circumstances in which a country can access the facility, the timing between a request for financial assistance and its delivery, the conditions attached to those credits, etc. will have critical implications for the effectiveness of this program to actually solve the liquidity issues facing some of these countries. Given that most of these fundamental elements are still on the drawing board, some skepticism is warranted until further details and implementation is hashed out. In this regard, the positive reaction from financial markets following the announcement of these measures suggests that the ECB's decision to buy debt in secondary markets has arguably been deemed the most effective portion of the entire policy set. This might be rooted in the fact that it does not depend on parliamentary approval (which requires political accord that is often hard to secure) and does not involve reaching an agreement on fiscal and structural adjustment programs, as is the case with traditional IMF loans. Instead, it assures the markets that, at the discretion of the ECB governing council, the bank can swiftly engage in debt purchases if a lack of liquidity is hampering a segment of the markets. To attest to this, the ECB already bought Italian and Portuguese bonds.

European Stabilization Mechanism is not a fix for underlying structural imbalances

To carry on with our analysis, let's assume the implementation of the ESM is such that it actually solves the immediate liquidity concerns. It still wouldn't solve the underlying fiscal and structural imbalances which are the cause for fiscal unsustainability in the longer term. The reality is that many of the European Union member states need to undergo significant fiscal consolidation processes in order to rein in their debt-to-GDP ratios. In our April 29th report we illustrated the magnitude of the challenge ahead for a group of European sovereigns (i.e. France, Germany, Greece, Ireland, Italy, Portugal, Spain and the United Kingdom) and also emphasized the negative feedback loop between fiscal tightening and weaker economic growth.

In spite of the latter, there have been instances in which fiscal consolidation has had a limited impact on economic growth. Some countries actually have experienced an upturn in overall economic activity during a fiscal adjustment period. For example, Spain fiscal surpluses averaged 1.7% of GDP during 2005-07, reverting from many years

GROSS DEBT AND FISCAL DEFICIT



Source: OECD, 2009

of deficits, and at the same time the country also improved its growth performance with respect to the three preceding years. It should be noted though that during 2005-07, revenues in the Mediterranean country were temporarily boosted by unsustainable booms in housing, construction and financial services.

However, this time around there are several factors that heighten the risk for a drawn out period of stagnant GDP growth. First on the list is the fact that many advanced economies across Europe (and elsewhere, notably the United States and Japan) will need to bring down their fiscal deficits at the same time, which reinforces the fiscal drag on overall economic activity. Second, prior to accessing the eurozone, these countries could devalue their currencies to improve their competitiveness. Granted, the euro will likely remain weaker in the near term, but it is still outside the control of each individual eurozone member. Therefore devaluation is not a tool available to the policymakers in the individual countries at this juncture. Third, the fact that the world is still recuperating from a deep recession also weighs down on the ability of both households and private corporations to withstand the impact of a higher fiscal burden and at the same time underpin domestic demand. So, for the eurozone as a group, this means that it will be increasingly dependent on external demand for its goods, particularly from emerging markets, to support the economic recovery and temper the impact of tighter across-the-board fiscal policies. In all, the current situation presents significant challenges in many fronts.

How big is the fiscal challenge?

To further illustrate the daunting fiscal challenge we computed the average yearly improvement in their fiscal balance (as a percentage of GDP) that would be required over the next ten years in the case of 6 European countries to prevent their debt-to-GDP ratios from breaching the 100% mark by the end of 2020. Moreover, we added the case of both Greece and Italy, where each country is showing a debt-to-GDP ratio of 130% and examine what amount of tightening is required to have their gross debt ratios decline to 100% of GDP by 2020. The accompanying table shows the results. For example, Greece would need to improve its fiscal balance by 3.1% of GDP every year during the next ten years to bring its gross debt-to-GDP ratio back to 100% by the end of 2020[1]. The table also shows the impact of such fiscal consolidation on lost GDP growth and increased unemployment[2].

We must emphasize that these figures and calculations are merely an illustrative exercise and do not represent our forecast (in the sense that, for the reasons outlined below, we assigned in most cases a small probability of these scenarios playing out in the future). As such, they legitimately suggest that for some of these countries, given their current unemployment rates and potential economic growth rates, it would be socially and politically extraordinarily difficult to implement such reductions in their fiscal stance for a prolonged period of time. Take Greece for instance, even after imposing drastic deficit cuts of 3.1% of GDP year after year, its debt-to-GDP ratio would still peak at 143% in 2015. At that point in time, it is not difficult to imagine a great level of public frustration and fiscal tightening-fatigue. Social pressures might become unbearable for a government which would have exhausted a lot of political capital during the process. This is particularly true for those countries with weaker institutions and relatively more polarized political environments.

Concluding Remarks

The analysis suggests two main conclusions. The first one is that fiscal tightening will very likely lead to a period of slow economic growth across Europe. The second is that even though the ESM has the potential to significantly reduce the likelihood of a sovereign default in the near term, from a longer term perspective, a managed debt restructur-

	Net Fiscal Improvement (yearly, % of GDP)	Impact on Growth	Impact on Unemployment	Potential GDP Growth	Unemployment Rate
France	2.0	-0.8	0.6	1.4	10.1
Germany	0.7	-0.2	0.5	0.8	7.4
Greece	3.1	-0.8	1.2	2.3	10.2
Ireland	2.6	--	--	-0.8	13.1
Italy	1.6	--	--	0.4	8.6
Portugal	1.5	-0.4	0.1	0.4	10.4
Spain	1.9	-1.6	1.4	0.8	19.0
United Kingdom	2.3	-1.4	1.1	1.4	7.7

Source: OECD, Haver Analytics, TD Economics ing process remains a significant risk for some European countries. For a country considering a debt restructuring, a few stylized facts from the economic literature on sovereign debt crises become very relevant.

The first stylized fact is that countries that have defaulted on their debt obligations in the past are more likely to default again in the future than those with the same debt-to-GDP ratio but no previous default experience. A second stylized fact is that a country for which default terms require less than a 100% recovery rate tend to pay higher returns (relative to a risk-free asset) on subsequent debt issuances than that paid by defaulting countries which agree to a full recovery[3]. In other words, once a country is confronting default, it faces a trade-off between lower current payments (a lower recovery rate for creditors) and higher future financing costs. Thus, depending on the extent to which a country foresees itself requiring financing in the future, it might be better off by offering a more favorable deal to creditors than to taking the easier, shortsighted approach of trying to impose significant reductions on the recovery value of its defaulted debt obligations. Argentina offers a good example of the implications of a poorly handled default. Its default of US$82.3 billion (30.6% of GDP) in 2001 and post-default renegotiation (37% recovery rate) in 2005 have left Argentina still unable to regain access to capital markets. The bottom line is that, even after entering a painful managed default, frontloading the sacrifice pays out in the future.

These should incent all social players to strive to reach an adjustment-sharing accord that maximizes the likelihood of the country achieving the largest possible deficit reduction in the shortest possible period of time. This would in turn reduce the odds of facing a debt restructuring. To conclude, we should mention that debt restructuring is a very complex process which could adopt several forms, all with different implications for both creditors and debtors. The good news is that the recently announced European Stabilization Mechanism gives countries some breathing room to implement fiscal reforms in the near-term. The bad news is that the fiscal challenges in Europe will remain a focus point over the next several years and the risks bear monitoring closely.

Endnotes

1. It should be noted that frontloading the deficit cuts during the early years reduces the total fiscal adjustment needed to achieve the same goal, and that extra tightening early on might come at a relatively lower political and social cost (i.e. for a high initial deficit cut say 3%-of-GDP, the political capital required to impose an extra 1% of GDP deficit reduction is arguably lower than that on the first three percentage points).
2. Estimates for Ireland and Italy are not reported due to insufficient data to compute econometric estimations.
3. See "Serial Default and Debt Renegotiation", by Tamon Asonuma, 2010, and the references therein.