What it would take to create a sovereign debt restructuring regime for the euro area

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"Sovereign Debt Crises: Prevention and Management"

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Preface: the theme of this conference is not about Italy today.

- Italy's sovereign debt is sustainable in the sense that putting the Italian debt trajectory on a downward sloping path would require only a modest fiscal adjustment – in essence, following the Stability Programme that had been proposed by the previous government, in April 2018.
- The current government's budget proposal is counterproductive in the sense that it does not raise growth in either the short nor the long run. But neither does it weaken Italy's fiscal solvency beyond repair. It merely postpones the timing of needed fiscal adjustment, and will make it more difficult to do the adjustment once it comes.
- For details, see Olivier Blanchard, Álvaro Leandro, Silvia Merler and Jeromin Zettelmeyer, Impact of Italy's Draft Budget on Growth and Fiscal Solvency, Policy Brief 18-24, Peterson Institute for International Economics, November 2018.

With this out of the way, what would be the essential features of an effective sovereign debt restructuring regime for the euro area? It would require main components.

1. Minimum legal requirements: A device to deal with the holdout problem, e.g. one tier-CACs.
    - Necessary, not sufficient
    - The easy part, and one that has now been agreed in principle by the Eurogroup (albeit with a long transition period).

2. Dealing with the time consistency problem: debt restructurings are costly and may look inefficient ex post even when they are efficient ex ante.
    - Standard approach: Hard commitment device, e.g. automatic debt restructuring as a condition for an ESM program for countries with D/Y>x%. Bad idea.
        i. Will not get several euro area countries to voluntarily participate ex ante
        ii. Very inefficient ex post: type II errors.
        iii. For this reason, probably not even credible.
    - **A better approach: reduce the costs of debt restructuring ex post** (Benassy-Quéré 2018) But how?

      Minimum package:
        i. Reduce sovereign exposures of banks. Regulation unlikely to be enough (plus could be destabilizing) – see Alogoskoufis and Langfield (2018). Hence, need safe asset plus regulation. Safe asset is feasible without guarantees.
        ii. Ensure private and public liquidity

        - Critical for high debt countries *ex ante*: deal with the possibility of self-fulfilling runs in the face of a more credible restructuring option
        - Provision of liquidity to sovereign during/after a restructuring
        - Prevention of runs on banks (EDIS)
        - Deal with spillovers to other countries (prequalification, e.g. meeting fiscal rules).

3. In the absence of rules-based commitment device: good discretionary decision-making by the ESM/EC.
    - Ensure good ESM governance (must be independent *and* accountable) and shareholder/stakeholder trust.
        - Must avoid a perception, in the "South", that the ESM is an instrument of the "North" – and as possibly biased toward private creditor interests (via lobbying of northern governments).
    - A device/approach to deal with uncertainty about solvency
        - Like IMF exceptional access rules: if not sure, roll over. Basis: rollovers less costly than deep haircuts (work by Aitor Erce, Tamon Asonuma and Christoph Trebesch).
        - Can only develop if the ESM is allowed to develop lending policies analogous to those of the IMF, which make its interventions more predictable and help commit its shareholders.