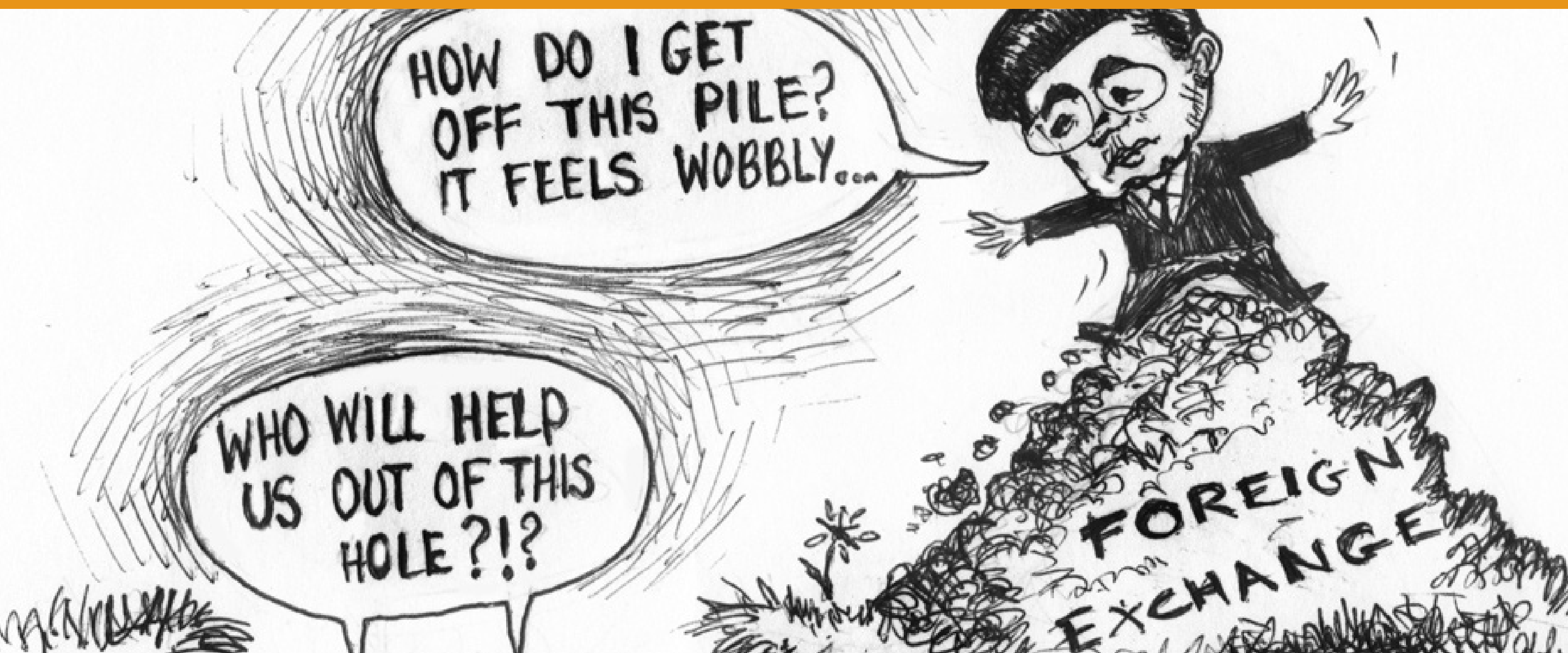
SALZBURG GLOBAL SEMINAR

SESSION REPORT

488

Unlocking the Debt Conundrum: Paths to Growth and Fiscal Sustainability Planning



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Session 488

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Unlocking the Debt Conundrum: Paths to Fiscal Sustainability and Growth

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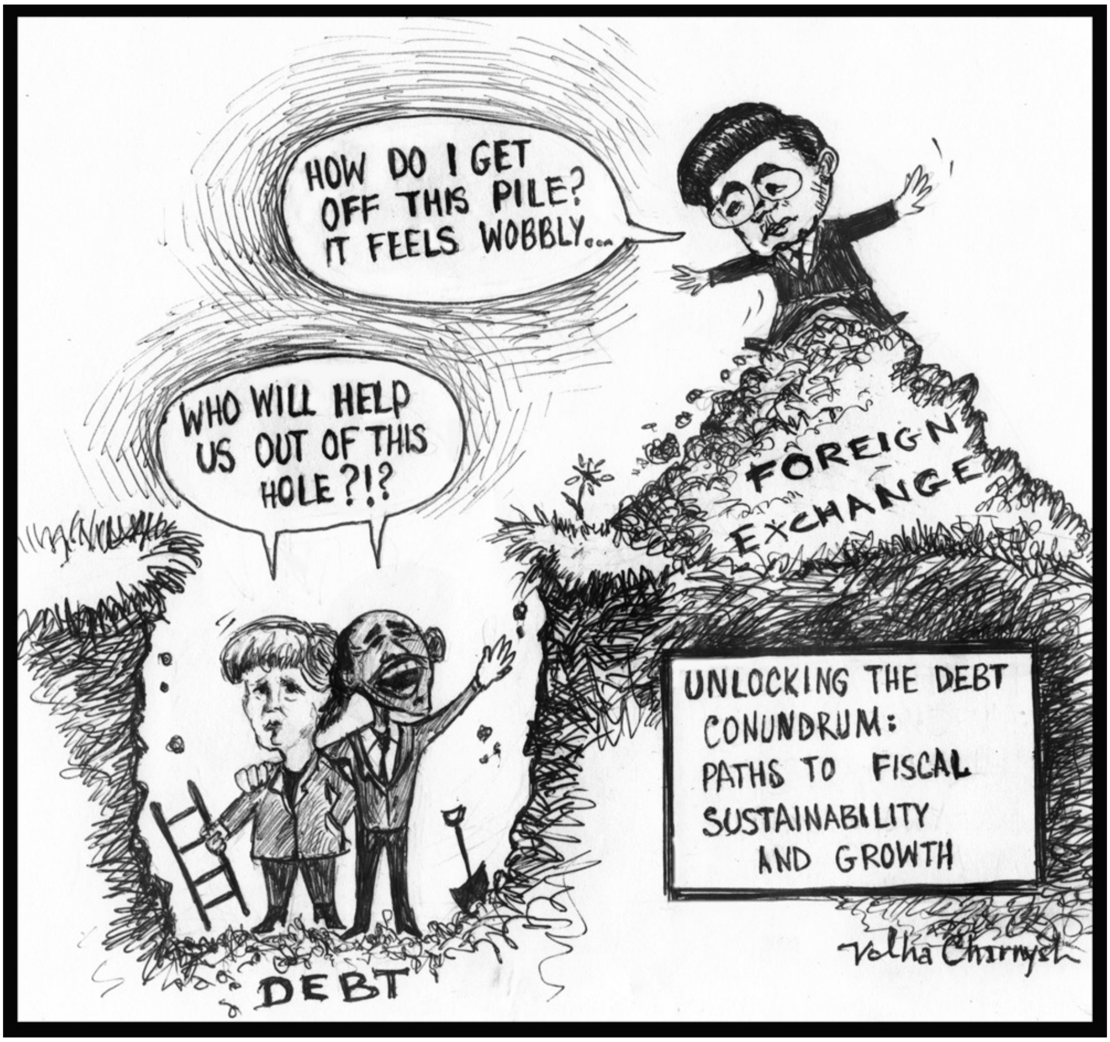

Session Report

At a planning workshop "Unlocking the Debt Conundrum" organized by the Salzburg Global Seminar in March 2012, economists and policymakers tried to reframe the debate surrounding the debt crises threatening developed economies. However, while experts suggested several measures that could prevent future crises, solutions to the eurozone's troubles remained elusive.

Since 2008, the global economy has been defined by one word: crisis. The financial crisis that shook financial markets in 2008 caused a worldwide recession, leaving many of the globe's advanced economies saddled with onerous levels of public and private sector debt. In many countries, the debt burdens continue to rise, as economic growth remains sluggish or negative.

Four years later, the era of crises shows few signs of drawing to a close. In fact, many predict there will soon be more debt crises. Flagging competitiveness, ageing populations and fiscal profligacy are each cited as the underlying causes of decline in the economies of the G10 group of nations.

A planning workshop brought together leading policymakers from a range of public and private sector institutions, in an attempt to think thematically about the debt crises afflicting many of the advanced economies and to reframe the debate surrounding the debt crises threatening developed economies. Present were young leaders from institutions including the European Central Bank (ECB), US and UK Treasuries and bulge-bracket banks, as well as academia.

The event consisted of six sessions tackling a trio of subjects presently being considered by policymakers across the developed world: how to stop a euro break-up; how to promote growth in the eurozone; and a review of European institutions.

The intervening months have seen the debt crisis remain an existential threat to the eurozone. The economic crisis has deepened, with the eurozone as a whole moving deeper into recession.

However, unlike the summer of 2011, there has been no panic in the financial markets. Indeed, a series of canny moves by Mario Draghi, president of the ECB, have seen spreads narrow across a range of peripheral sovereign-debt instruments, in particular easing some of the pressure on the leaders of Italy and Spain.

With Draghi's threat of unlimited purchases of peripheral sovereign debt being considered by markets, the world waits to see what will happen next. Will Spain, as many believe, be forced to accept a full sovereign bailout? Will Italy need to follow suit? And will the ECB find a way to provide assistance – on the grounds of alleviating failed monetary transmission mechanisms – without being exposed to the kind of moral hazard feared by the electorates of many northern European states?

Initially, the meeting focused on creating structures to ensure the prevention of future crises. However, prevention presupposes the prior detection of the symptoms of such events. Many of the standard measures used by economists to determine

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the risk of sovereign default before 2012 proved woefully inadequate, with triple-A rated countries such as Ireland suddenly brought to the brink of default.
One factor cited by many analysts as a contributor to this failure was that most of the techniques used to conduct debt-sustainability analysis on developed economies were originally developed to deal with the emerging market debt crises of previous decades. Measures such as a country's government debt to GDP, current account balance and foreign exchange reserves have for many years been used by markets to price the sovereign debt of countries where default is considered a genuine threat.

However, the present crisis involves countries with full access to financial markets, whose debt was supposedly free from default risk. After the global financial crisis and the work of economists such as Nouriel Roubini, it has become clear that the detection of potential threats to sovereigns must include a much broader economic assessment.

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The case of Ireland, whose net government debt was a mere 10% of GDP in 2008, before a banking crisis pushed it up to 110% GDP in 2011, is commonly cited as an example. Similarly, Spain's public accounts were irrelevant when its massive housing bubble burst, leading to the banking crisis that might yet force Spain to accept a conditional sovereign bailout.

Assessing the indebtedness of developed economies is a minefield in itself. Three hurdles were identified by the panel.

1. Accurately calculating the total outstanding public debt stock of a country is, in practice, notoriously difficult. Few governments can claim to publish balance sheets in the same way that public companies are obligated to.

2. The status of government debt owned by a central bank is also unclear, in an era of unprecedented monetary easing by central banks in the developed world.
3. Practical questions remain over whether there is a distinction between official government debt and pension liabilities, or whether debt issued to fund capital spending ought to be viewed in the same light as debt to fund social spending.

Private sector debt also played a large part in the public debt crisis, with many members of the panel viewing the distinction between public and private sector debt as largely useless. “Private sector debt is almost always a public sector liability,” said one well-known economic commentator.

Risk analysis must look further and include factors such as future pension liabilities, off-balance-sheet financing, banking sector stability and corporate solvency. Perhaps also, one must consider a kind of formal generational accounting, to prevent politicians funding social spending at the cost of increased future taxation.

Whatever the methodology, a global framework is needed for pre-crisis detection for countries that rely on markets. As one senior official from the IMF put it:

“The whole notion of ‘sustainable’ debt was never asked of advanced economies. Solutions are required not simply to reduce debt, but how to manage concerns that countries with unbridled market access and huge connections between sovereign and private sector balance sheets can continue to rely on access to capital markets for funding needs.”

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Three initiatives suggested by the panel are especially worthy of consideration by policymakers.

1. Sovereign insolvency itself needs to be adequately defined. Does it mean the inability of a state to pay its debts today, tomorrow or at some unspecified point? In incidents of private sector insolvency, the typical approach would be to value balance sheets, but governments do not really have a balance sheet. In many cases, governments are constrained from refinancing by their debt levels and the size of their foreign exchange portfolio. However, someone is needed to bring these figures together.
2. There is no official mechanism through which a sovereign can enter insolvency. Finding a sanctioned route and body of law to facilitate sovereign restructurings would calm creditors and lead to easier default resolution in future.
3. On the macro-financial side, governments need to look closely at their risk-management programmes. At present, different types of government debt are managed by different departments, specific to each source of funding. The SGS panel suggested governments should take a leaf out of the private sector’s book by introducing a chief risk officer, to look at sovereign liabilities in a more forward-looking manner.

In addition to the detection of future crises, the present problems of the eurozone naturally engaged the thoughts of delegates. Many considered the perceived

German strategy – which centres on a solution to the crisis via the Stability and Growth Pact (SGP), without an accompanying transfer union – to be a mistake. It was argued that the German emphasis on fiscal discipline misdiagnosed the causes of the crisis, failing to address the macro-imbalances many consider fundamental to the problems of the eurozone.

However, there was general agreement that the situation had improved since November 2011 and that much had been achieved in the intervening months. The unorthodox monetary stimulus of long-term refinancing operations (LTRO) was the single most-important policy initiative enacted in this period, providing a three-year solution to the liquidity crisis threatening Europe's banks.

With the enaction of the Eurogroup's four-pronged strategy – broadly characterized as private sector restructuring in Greece, the creation of the European Stability Mechanism (ESM) alongside the SGP, the prevention of further debt restructurings elsewhere and LTRO – Europe's leaders could finally be said to have a coherent strategy to manage the crisis, even if that strategy is predominately short term in orientation.

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Among the key conclusions of the group, a few home truths stood out as sombre reminders that neither private sector involvement (PSI) nor LTRO have solved the problems facing Europe's banks and sovereigns.

So many vulnerabilities remain unresolved: the inadequacy of the European Financial Stability Facility, or its replacement, the ESM, to protect embattled sovereigns; the danger of event risk due to multi-faceted political process in Europe; the elevated debt levels of both public and private sector debt across the eurozone;

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the un-severed link between banks and sovereigns; and the unresolved political questions of governance, enforcement and legitimacy.

Multiple trigger events for the next acute phase of the crisis lie ahead. Greek default risk was partially addressed by the PSI agreement, but default in 2014, when large repayments to the official sector have been rescheduled, remains a real possibility. Greek policymakers will have increased leverage as soon as the country reaches a primary surplus, forecast to take place early next year.

Indeed, political risks across the continent are rife. A collapse of the Mario Monti coalition government in Italy would refocus investor attention on Italy’s mountain of government debt. Should Spain’s economy enter a death spiral, the markets are likely to test the shaky crisis-management architecture being constructed by policymakers.

Much mistrust also exists towards French president François Hollande, whose anti-German views towards the SGP could panic markets were he to demonstrate a show of fiscal discipline in the coming months.

Senior policymakers – in the ECB and elsewhere – also remain terrified of an oil-price shock – potentially triggered by a further deterioration in relations between the US and Iran – which could result in a fundamental change in Europe’s terms of trade. Europe’s external surplus is one of its few remaining strengths.

Nevertheless, all present were agreed that undoing European integration would be the riskiest option policymakers could take. With US-style federalism no longer an option, a much larger ESM is perceived to be a more plausible option than Eurobonds. However, failure is unthinkable, politically and economically, both for Germany, which has vigorously opposed the creation of a transfer union,

and elsewhere in the embattled union. As one present senior commentator put it: “Failure just has to be ruled out.”

There was also broad agreement that no country will be ejected from the currency union. The costs of such an exit – allied to the nightmarish legal implications – mean European policymakers will not attempt to force a euro exit on any nation.

With any country that exited the euro facing the prospect of leaving the EU – to avoid being liable to litigation over the violation of private sector contracts – few are likely to take this route.

Many believe the acute phase of the crisis, which lasted from June to November last year, was a missed opportunity to bolster the ESM, by increasing its size and powers, which will likely lead to a further crisis. This crisis will present opportunity for fiscal union, which many believe must not be wasted.

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Salzburg Global Seminar

Founded in the wake of World War II, Salzburg Global Seminar brings together emerging and established leaders from every region of the world to broaden thinking, challenge perspectives, encourage collaboration, and build networks that support future cooperation.

Without adopting any political agenda of its own, the Seminar asks critical questions on the most pressing topics of our times.

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Rather than being just a space for speakers to deliver presentations, seminars are designed to move participants beyond their 'comfort zones', by being participatory, prompting candid dialogue, fresh thinking and constantly in the search for innovative but practical solutions.

The Seminar program convenes imaginative thinkers from different countries, cultures and institutions enabling them to forge connections across national, cultural and professional boundaries. In this age of globalization and the cross-border, multinational and interdependent issues that it brings, these connections are vital to finding solutions to the complex problems that the world now faces – connections that will continue to remain useful during the coming decades as our emerging leaders themselves progress on to more senior positions.

Our sessions are devised with timeliness and pertinence in mind. Because of our desire to respond to a rapidly changing global environment, our program is under continuous development, so please check the calendar on our website for updates.

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