



Kiel Institute

for the World Economy

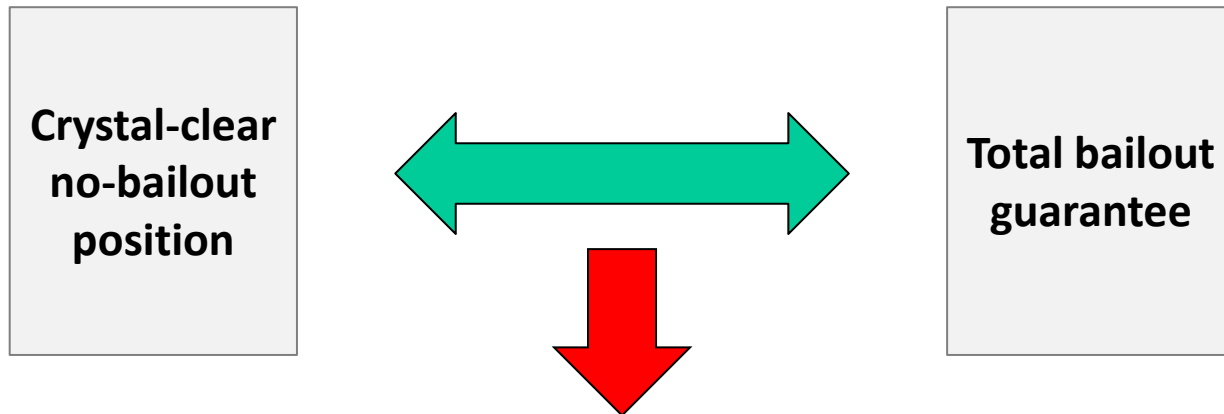
Kiel Institute Policy Lunch at the Hertie School of Governance
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Resolving the Eurozone Debt Crisis

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Forecasting Center and Office Berlin

Stuck in the middle ...

... the worst place to be



Markets are faced with extra “rescue risk”
(guess about intentions of EU/IMF officials and
future lobbying success)

Restoring market mechanisms (1)

- Negation of sovereign insolvency eliminates basic idea of risk premia
 - 2 % risk-free interest rate
 - 50 % haircut (neutral to final value) every ...
 - ... 72 years (100 bps risk premium)
 - ... 36 years (200 bps risk premium)
 - ... 24 years (300 bps risk premium)
- ⇒ Sovereign insolvency framework for (re-)establishing credible risk-awareness
- ⇒ Equity cushion for sovereign bonds



Restoring market mechanisms (2)

- Permanent intra EA balance of payments financing via ESCB (Target2)
 - 25 % of monetary base issued by CBs of Greece, Portugal, and Ireland (6 percent of EA GDP)

- Capital markets are out of the game (no market-based credit sanctioning)

- ⇒ Reinforcing temporary (clearing) character of Target2 system

Spill-over effects?

- Greece is different
 - Ad hoc “correction” of deficit figures
 - Extremely high debt-to-GDP ratio, high (unsustainable) debt servicing burden
 - Poor attractiveness for FDI, small degree of openness, low investment ratio
 - Doing Business Index (World Bank): #109
- ⇒ Large distance even to “next” candidate Portugal



Contagion and multiple interest rates

- Investor confidence matters
 - Greek bailout itself negatively affects the fiscal position of other EA countries

- Maturity structure matters (roll-over risk)
 - Long-term financing comes with extra cost ...
... and extra benefits
(insurance fee against solvency crises)
 - Short term borrowing only looks cheaper

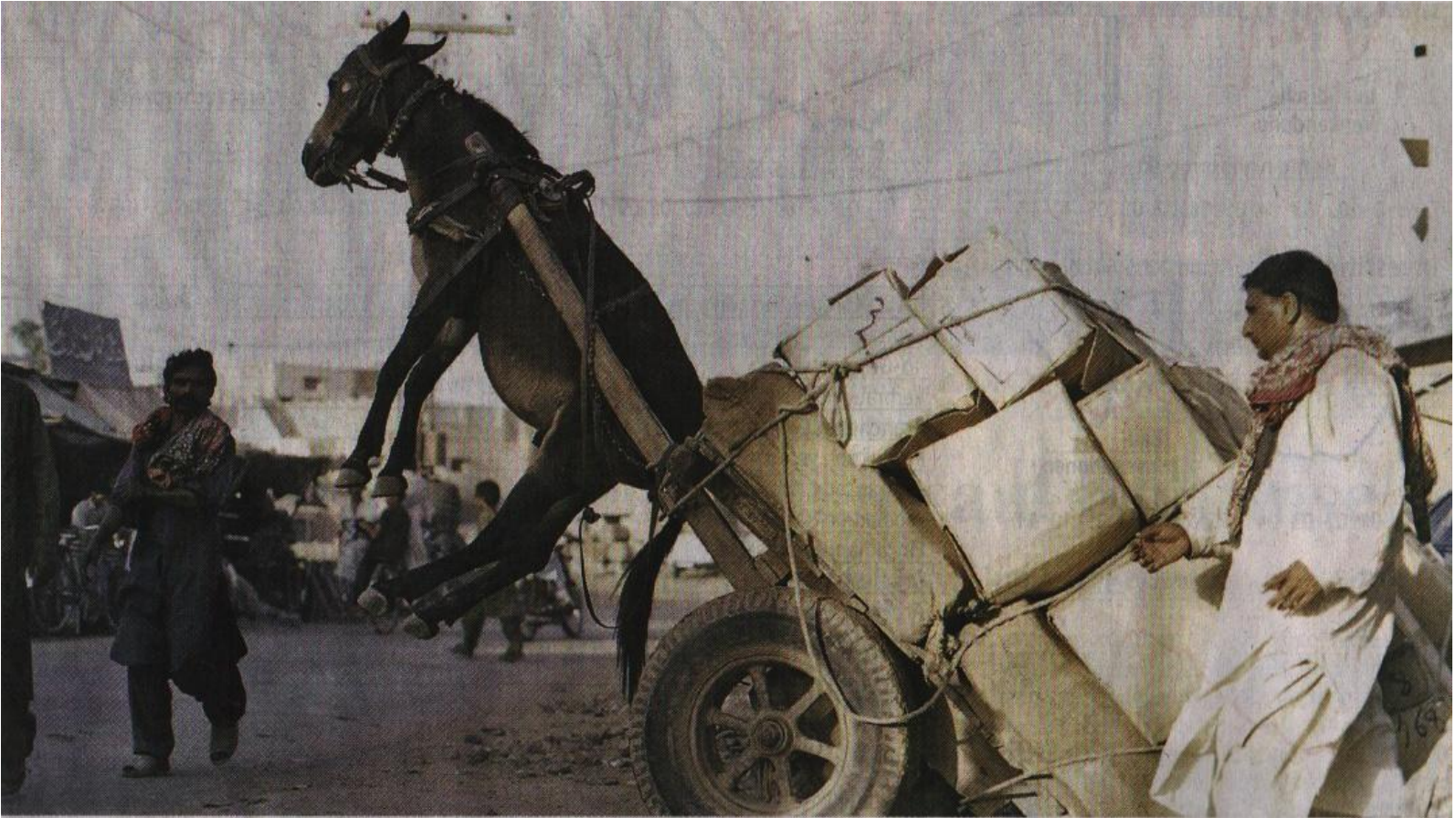
Financial stability

- Principle of Financial Subsidiarity
 - Level 1: Full mobilization of private loss absorption capacity (no “voluntary” participation)
 - Level 2: Full mobilization of national “bail-out” capacity (compulsory recapitalization)
 - Level 3: European rescue facility

- Strengthening banks’ equity buffers
 - Differentiated ECB refinancing conditions (~ absolute equity position to avoid deleveraging incentives)
 - Contingent convertible capital (debt which converts into equity once a certain trigger is breached)

Role of EFSF

- Euro Area wide rescue net for banks, not for governments
- Limited capacity (440 bn)
 - 109 bn Greece II (79 bn with IMF package)
 - 26 bn Portugal
 - 18 bn Ireland
 - ⇒ 287 (317) bn available funds
(= 28 weeks of current ECB purchasing programme)
- Funds should be used exclusively for (compulsory) recapitalization of banks
 - Insurance model comes with wrong incentives
 - Leverage puts further stress on EA member states



Source: FAZ, 26 October 2011, p. 11

Key direction

- European Central Bank
 - Last remaining institution with sufficient credibility
 - Bailout via CB looks cheap ... until it is too late
 - Current sterilization is not neutral
 - Supra-national architecture without centralized fiscal counterpart strengthens independence
- Significant limitation on the fiscal sovereignty of member states
 - Self-restraint: Fiscal rules, debt commissions
 - EMU regulation (fiscal union)

⇒ **Back to Maastricht**