EUROPE: THE LIGHT AT THE END OF THE TUNNEL IS STILL TWO TO THREE YEARS AWAY

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Willem Buiter
Chief Global Economist

Europe's balance sheet recession

Balance sheet obstacles to sustained domestic demand growth mean that the euro area (i.e. countries in the EU which have adopted the euro as their currency) — and most of the rest of the EU — face two or three more years of recession and tepid cyclical recovery, even if EU policy makers enact the right measures as fast as their glacial decision-making processes allow. The balance sheet recession is caused by excessive leverage: zombie banks throughout the EU, excessive sovereign debt and deficits in the periphery, and excessive household indebtedness in many countries, both in the periphery of the euro area (Ireland, Portugal and Spain), the core of the euro area (the Netherlands) and EU member states outside the euro area (notably the UK, Denmark and Sweden). There are even some euro area countries where the non-financial corporate sector is excessively indebted — Ireland, Spain and Portugal come to mind. Unfortunately, we cannot be sure that even when the deleveraging progresses is complete and domestic demand expands again, growth will be more than that of a cyclical recovery. For the growth rate of potential output to rise, deep structural supply-side reforms are needed. Currently, even the most ambitious reformers in the EU are only scratching the surface of what is needed and many among the political leadership still believe it is possible to legislate and regulate prosperity and social protection for all without considering how this affects sustainable wealth creation.

Deleveraging will not come through growth, as growth will not return until deleveraging is completed. It also will not come through inflation because the ECB will not inflate. The debate between Spendarians and Austerians has little relevance as only Germany is in a position to provide a significant discretionary fiscal stimulus and just a few more countries (the Netherlands, Finland and perhaps France) may be able to let the automatic fiscal stabilizers operate. If countries under the Excessive Deficit Procedure or on troika programmes wish to spread the pain of austerity over a longer period, then they will either have to convince the markets to fund them or ask the troika for additional concessional funding.

For most countries, the level of austerity (as measured by the cyclically corrected or structural general government balance as a share of GDP) will be higher this year than last, but less than it would have been without the European Commission and International Monetary Fund's retreat from their past positions in support of excessively pro-cyclical austerity. Another positive development is the elimination of Cyprus as a tax haven and the contribution this is making to the rapid elimination of bank secrecy in tax havens in or near the EU and in UK overseas territories. This creates new, less demand-destroying revenue opportunities through wealth levies, including tax amnesties that may prove valuable to countries like Italy.

Deleveraging through debt mutualisation and restructuring

The main instruments of deleveraging will be debt mutualisation and debt restructuring. Euro bonds will not be used in the same way that the US 'general obligation bonds' — i.e., bonds secured only by the full faith and credit of the issuer, that is, by the issuer's realizable assets or by its (generally limited) taxing power or power to cut public spending — are issued. Although there may be some limited issuance of instruments labelled 'Euro bonds' for the purpose of funding infrastructure projects and similar public goods, and secured by revenues derived from tolls, charges, fees or rents from facilities built with the proceeds of the bond issue – what in the US would be called 'revenue bonds'. Nor will general obligation Euro bonds be issued to deal with the stock problem of legacy excessive sovereign debt or with the flow problem of funding future general government deficits in the periphery. Euro bond issues would only be feasible as part of a significant, symmetric move towards additional fiscal union, including a material surrender of national budgetary

AUTHORS

Stephen Antczak, CFA
Robert Buckland
Willem Buiter
Jay Collins
Deane M Dray, CFA
Tina M Fordham
Jeremy Hale
Hans Lorenzen
David Lubin
Guillermo Mondino
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sovereignty – but there is little or no political support for this. Open-ended, uncapped joint-and-several guarantees from the core euro area nations for the legacy debt or future debt issuance of the periphery nations without a commensurate surrender of national fiscal sovereignty by the beneficiary nations to the creditor nations or to a supranational euro area fiscal authority with material independent borrowing and taxation powers would be viewed as illegitimate in the core. It would precipitate a break-up of the monetary union through an exit of the strong.

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The unwillingness to engage in significant unrequited cross-border transfers between the nations of the Eurozone should not be surprising. Even inside well-established nation states, the willingness to engage in material inter-regional redistribution of resources is fading fast. In the UK, opinion polls have shown greater proportional support for Scottish independence in England than in Scotland. In Belgium, rich Flanders wants to reduce the open-ended transfers to poorer Wallonia. In Spain, rich Catalonia resents persistent net transfers to the other, less affluent autonomous regions. In Italy, the affluent North resents the never-ending drain of resources to the south – the Mezzogiorno. Even in Germany, public opinion no longer favours transfers to the former German Democratic Republic funded by the “Solidarity” income tax surcharge introduced in 1991 to help rebuild eastern Germany. So until a European ‘demos’ emerges that is comfortable with significant cross-border redistribution among the euro area or EU member states, calls for Euro bonds are likely to be viewed as special pleading by those who invested in periphery sovereign debt on terms that did not fully reflect the differential sovereign risk premia that have emerged since they took the plunge.

Mutualisation of sovereign and foreign debt

Instead of the large-scale mutualisation of outstanding privately held periphery sovereign debt (let alone joint-and-several guarantees for new euro area sovereign debt issuance), there will be some limited ex-post mutualisation of periphery debt to official creditors, as the outstanding debt of troika programme countries to their sovereign creditors is gradually converted into a zero-coupon perpetuity, promising to pay nothing forever. Considering the repeated maturity extensions, interest rate cuts and interest payment deferrals on debt owed to the Greek Loan Facility and the European Financial Stability Facility (EFSF) by Greece, Ireland and Portugal, the process of transforming these loans into zero coupon perpetuities, with full face value and zero net present discounted value, is well under way. No doubt loans extended or about to be extended by the European Stability Mechanism (ESM) will suffer the same fate.

There will also be some more mutualisation of sovereign debt issued by insolvent sovereigns and of bank losses when the European Central Bank (ECB) takes losses on its exposure to likely insolvent sovereigns and to likely insolvent banks that have offered substandard collateral. But this will not suffice to deleverage quickly.

Debt restructuring: the likely workhorse of deleveraging in the EU

Debt restructuring in the EU should have started in 2008 or, at the latest in 2009. Instead, excessively indebted banks, sovereigns and households have gambled for resurrection, hoping that low interest rates and moderate economic growth would allow them to rebuild balance sheet strength organically. The periphery sovereign debt crisis that started in 2010 and the second leg of the euro area-wide banking crisis killed off growth and brought high funding costs for risky borrowers despite unprecedentedly low safe rates of interest.

Now that restructuring is unavoidable in many cases, the need to address the inadequacy of the legal and regulatory framework for debt restructuring can no longer be denied. Only for non-financial corporates are there reasonably adequate national insolvency or bankruptcy laws, procedures and practices in most of the European Union member states. There exists no EU-wide or euro area-wide sovereign debt restructuring mechanism or sovereign default resolution mechanism (SDRM) worth the name. National arrangements and authorities for the orderly and swift recovery, resolution and recapitalization of banks in the EU exist only in a handful of countries. Fortunately, progress towards completing this key component of banking union is being made. Restructuring household debt swiftly, efficiently and fairly is impossible in many EU member states because of cumbersome or completely unworkable personal insolvency regimes and badly designed laws governing foreclosure on residential mortgages. In countries hard hit by some combination of excessive household mortgage debt and a sharp drop in house prices, there is enormous political pressure for changing personal insolvency and foreclosure laws to help borrowers at the expense of lenders. Spain and Ireland have been at the forefront of such legal changes. The Netherlands may not be far behind.

In line with the agreement reached to manage the Cyprus crisis, the new template for bank resolution bails-in the existing shareholders first, followed by all unsecured creditors (by seniority), including if necessary the noninsured depositors. Domestic taxpayers are no longer automatically subordinated to senior unsecured bank creditors. Once the single supervisory mechanism (SSM) under the leadership of the ECB comes into force, the ESM will be able to directly recapitalize banks. German proposals to delay this and to forbid the ESM from recapitalizing banks with ‘legacy’ capital needs (that is, capital needs caused by losses incurred on assets acquired before the SSM took over effective supervision responsibilities for the banks of the euro area) are likely to be shelved after the German elections, provided bail-ins of shareholders, unsecured creditors and domestic tax paye rs occur before the ESM mutualis es any residual capital shortfall for

systemically important banks.

The European Parliament and the European Commission are preparing a Directive for a network of national bank recovery and resolution mechanisms for EU member states. Transposition of this Directive into national laws could be complete by the time of the German elections. Although this falls short of a single European bank resolution regime, it will accelerate the recovery or resolution of EU zombie banks, especially if the Directive contains useful strategies for cooperation and coordination when cross-border banks need resolution. The ECB will soon start a euro-area Asset Quality Review that is likely to be conducted by independent experts, without excessive interference by captured national supervisors. By the end of this year, the informational and institutional toolkit to de-zombify the euro area banking system could be in place. Recent statements by German finance minister Schaeuble and Dutch finance minister Dijsselbloem (also head of the Eurogroup of euro area finance ministers) support this optimistic interpretation.

Sovereign debt restructuring by bailing-in private creditors will not remain confined to Greece — Cyprus, Portugal and Spain are also at risk. Even Italy's sovereign creditors are threatened because of the seeming inability of its political institutions to deliver growth-enhancing structural reforms. Unfortunately, there has been no meaningful progress on the creation of a euro area or EU-wide sovereign debt restructuring mechanism or SDRM with both a strong contractual and a statutory dimension. The only manifestation of progress on the contractual or market-based pillar of the SDRM has been the requirement that from 1 January 2013 onwards, all new euro area sovereign debt with a maturity longer than one year has to include collective action clauses, or CACs, which allow a supermajority of bond holders to agree to changes in bond payment terms and thus reduce the risk of hold-ups in sovereign debt restructuring by a small number of bond holders. However, only 55 percent of overall sovereign debt issuance in 2013 will be required to contain CACs because up to 45 percent of 2013's issuance can be achieved by increasing the size of old, pre-2013 bond issues. Not requiring all debt issuance from 2013 to include CACs represents an obvious missed opportunity. Also, free-rider problems are only mitigated by CACs, not eliminated. It is therefore most disappointing that no statutory mechanism was created as part of the ESM that would have given the ESM the power to impose sovereign debt restructuring terms on all parties in case of a failure to reach a sovereign debt restructuring agreement through voluntary mechanisms.

There is nothing inevitable or deterministic about the realization of possible sovereign risk in any of the other euro area member states. The countries involved are all rich countries by any metric — countries that could easily keep their sovereign creditors, private and public whole, given aggressive and far-reaching supply-side restructuring, a comprehensive reform of the welfare state and political consensus on a fair and efficient distribution of the costs of austerity and reform.

Stating this list of conditions for avoiding further sovereign defaults in the periphery of the euro area is, of course, also a sobering reminder of how far removed the political classes in the periphery are from mobilizing popular and political support for this reconstruction of Europe. Should further sovereign debt restructuring through private sector creditor bail-ins turn out to be politically unavoidable, early resolution is preferable to economically costly and politically unsustainable additional austerity and pointless concessional funding. The inherent disruption is minimized through early, coordinated and simultaneous debt restructuring of banks, sovereigns, households and non-financial corporates, of sufficient size to convince markets there won't be an early repeat of the exercise. Losses would be less than those created by further delay. Easy, really.

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