Sovereign Debt: A Cause for Concern?!

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* Views expressed here are my own and do not represent in any way those of Tudor Investment Corporation

Does sovereign debt really matter?

		Vulnerability indicators (In percent of GDP)							
	A	B	A+B	C	D	C+D	E	F	G
	2011 CA balance	2011 Gov balance		Gov debt	Private sector credit		NFA	Rating	CDS
Greece	-2.9	-8	-10.9	137	114	251	-89	BB-	1023
Ireland	-0.8	-12.2	-13.0	113	320	433	-102	BBB+	625
Portugal	-5.3	-5.5	-10.8	99	234	333	-113	BBB-	571
Average	-3.00	-8.57	-11.6	116	223	339	-101		740
Spain	-3.9	-6.7	-10.6	78	227	305	-94	AA	218
Italy	-3.6	-4.4	-8.0	133	121	254	-21	A+	144
Belgium	1.2	-4.5	-3.3	100	217	317	45	AA+	132
Average	-2.10	-5.20	-7.3	104	188	292	-23		165
France	-2.1	-6.4	-8.5	84	154	238	-12	AAA	72
UK	-1.7	-9	-10.7	89	217	306	-23	AAA	52
US	-3.2	-8.7	-11.9	99	169	268	-19	AAA	40
Average	-2.3	-8.0	-10.4	91	180	271	-18		55
Netherlands	5.9	-4.6	1.3	78	222	300	17	AAA	38
Germany	4.6	-0.5	4.1	75	134	209	38	AAA	44
Average	5.3	-2.6	2.7	77	178	255	28		41
EMU	-0.1	-4.3	-4.4	93	161	254	-12		142

Economic policy with high public debt

- Economic policy with high public debt
  - Bonds vs credit – can't adopt optimal policies (i.e. bank rescue)
  - Non linear/threshold effects – size matters (Greece/Ireland/Portugal)
  - Domestic vs Foreign ownership
    - Spain CDS 234 vs Italy 145 – why?
  - Domestic vs Foreign currency
    - Spain AA vs UK AAA – why?

5yr CDS	
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Ireland	625
Portugal	571
Iceland	220
Spain	218
Italy	144
Belgium	132
EMU	142
UK	52
US	40
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Source: Bloomberg	

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Economic policy with high public debt

- Liquidity vs solvency
  - Risk is rollover, not coupon payment
  - Willingness, not capacity, to pay
  - Unless supranational forces default
- Who to default on
  - Entitlement bubble vs revenue bubble
  - Bonds vs pensions vs health care
  - US pundits to EU: default on bonds now
  - But debate on US States bankruptcy bill: default on bonds is a very bad idea

$\Rightarrow$Default: demand and supply shock

$\Rightarrow$Adjustment: only demand shock

The European story

- EMU, child of the Great Moderation. 4 assumptions:
  - SGP: Balanced budget, small surplus, enough
  - ECB vs political economy of fiscal surpluses
  - CA doesn’t matter if EMU works
  - Financial market integration vs national banking policies, possible
- But:
  - Post Great Moderation shock
  - Greek “surprise”
  - Deauville self inflicted hit

=> EMU stops working, game over.

=> 4 lessons. Deep change in EMU economic policy infrastructure

Insuring the European Future

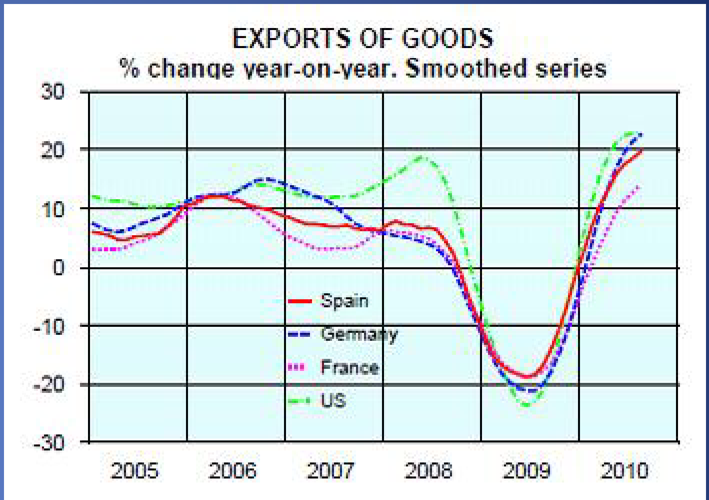
- **Lesson # 1 (learned): SGP not enough. EMU needs an (conditional) insurance mechanism**
- Ex ante vs ex post fiscal union
  - Alternative is self insurance – CA surplus
  - Alternative is financial re-nationalization – end of EMU
- EFSF – ESM
  - Flexible mandate
  - Moral hazard vs sustainability
  - Mutual agreement, not unanimity
  - PSI: case by case, consistent with IMF practices, and taking into account implications for euro area stability –> last resort.
  - CACs: nuisance, useless, and costly

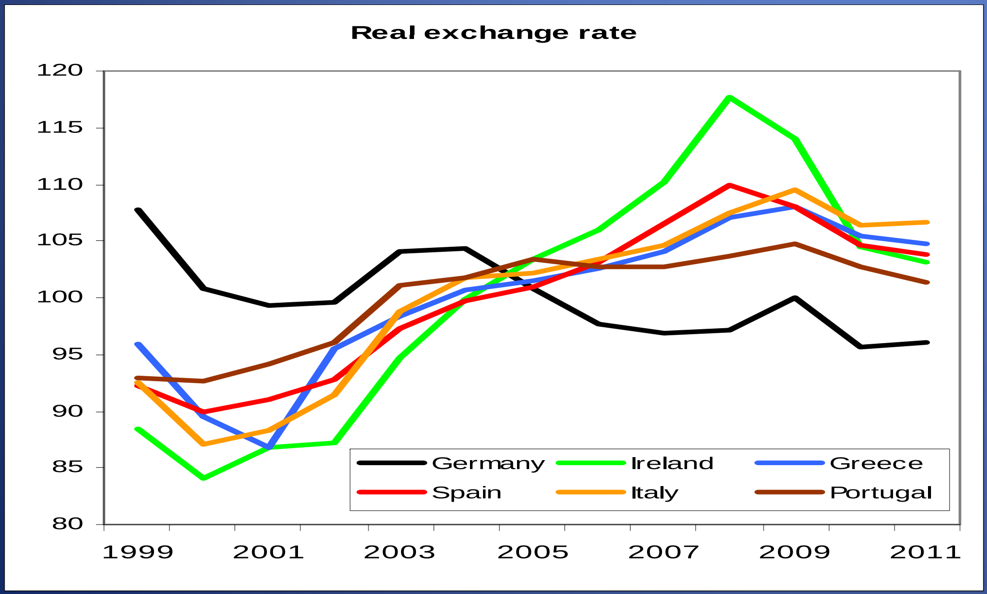
Insuring the European Future

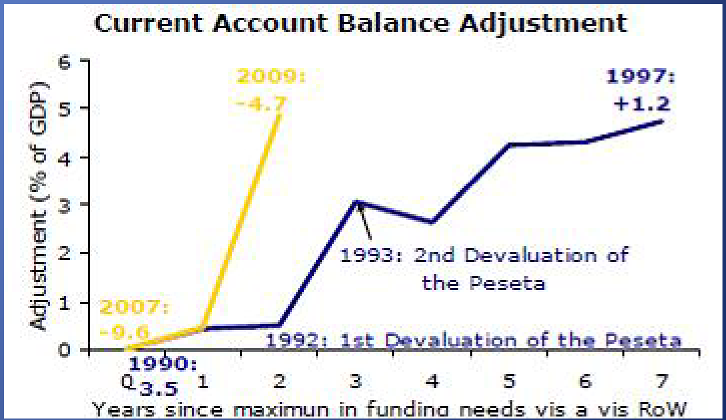
- **Lesson # 2 (learned): Political economy of fiscal surpluses requires stronger commitment/incentive for fiscal discipline**
- European Semester + SGP: surveillance before and after national budget discussion
- Need legislated fiscal rules to complement insurance mechanism
  - Germany :debt brake
  - Spain : spending ceiling
  - France: multi-period budgeting.

Insuring the European Future

- **Lesson (half learned) #3: CA deficits matter**
- Intertemporal budget constraint vs catching up: destination of CA deficit key
- Euro Plus Pact: improve competitiveness
  - Is that all? REER vs competitiveness vs credit growth

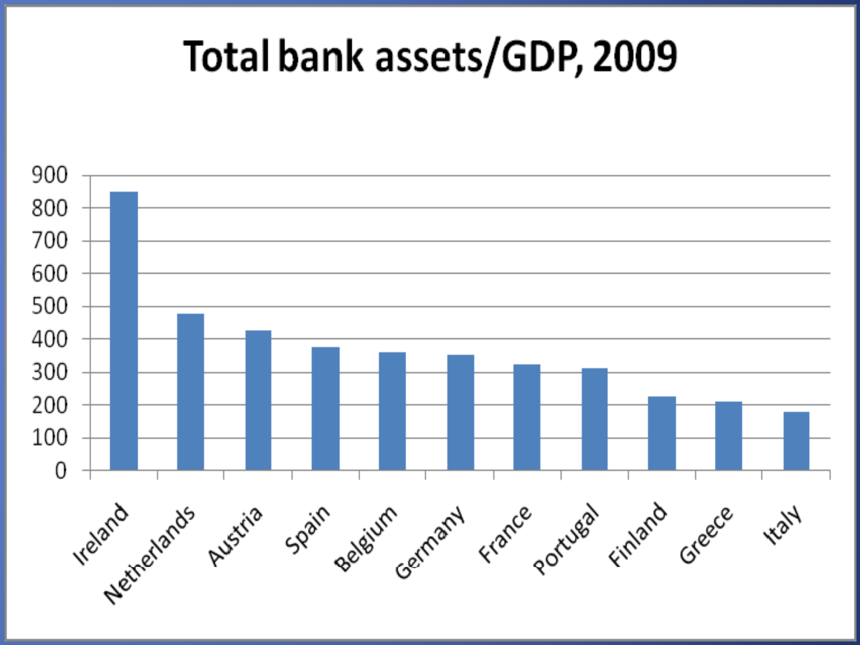






Insuring the European Future

- **Lesson (not learned) #4: Need European banking resolution capacity**
- Harmonized legislation and stress tests not enough
- Otherwise, banks too big to save
- ESM Trojan horse: mandate can be amended to be bank resolution capacity.



The next few years

- Solvency is the integer of liquidity – grow out of it with help
- The (r-g) problem
  - r low enough – possible. ESM’s primary market purchases.
  - g strong enough for long enough - possible
    - How high is potential growth?
    - How long will the next business cycle be?
- Political fatigue in adjustment countries – possible, but more reform in 1 yr than in 10 yrs.
- Orderly liability management
- EU countries to self insure – CA surplus
- 2013 elections in Greece and Germany.

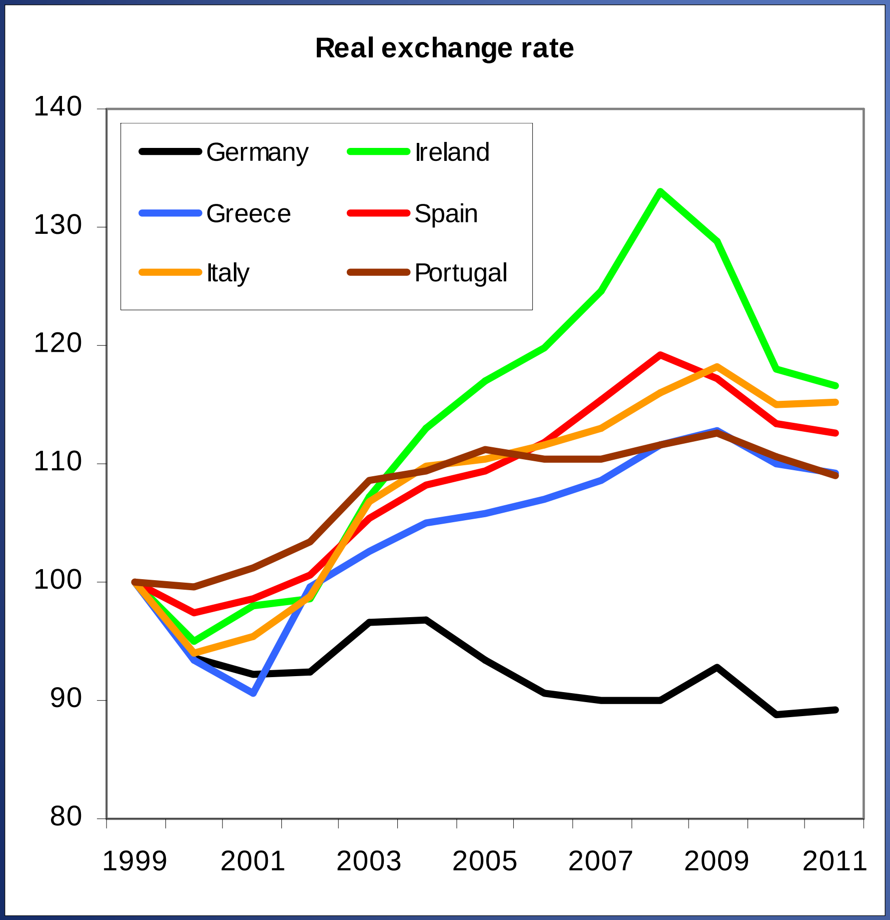
Final thought: monetary policy with high public debt

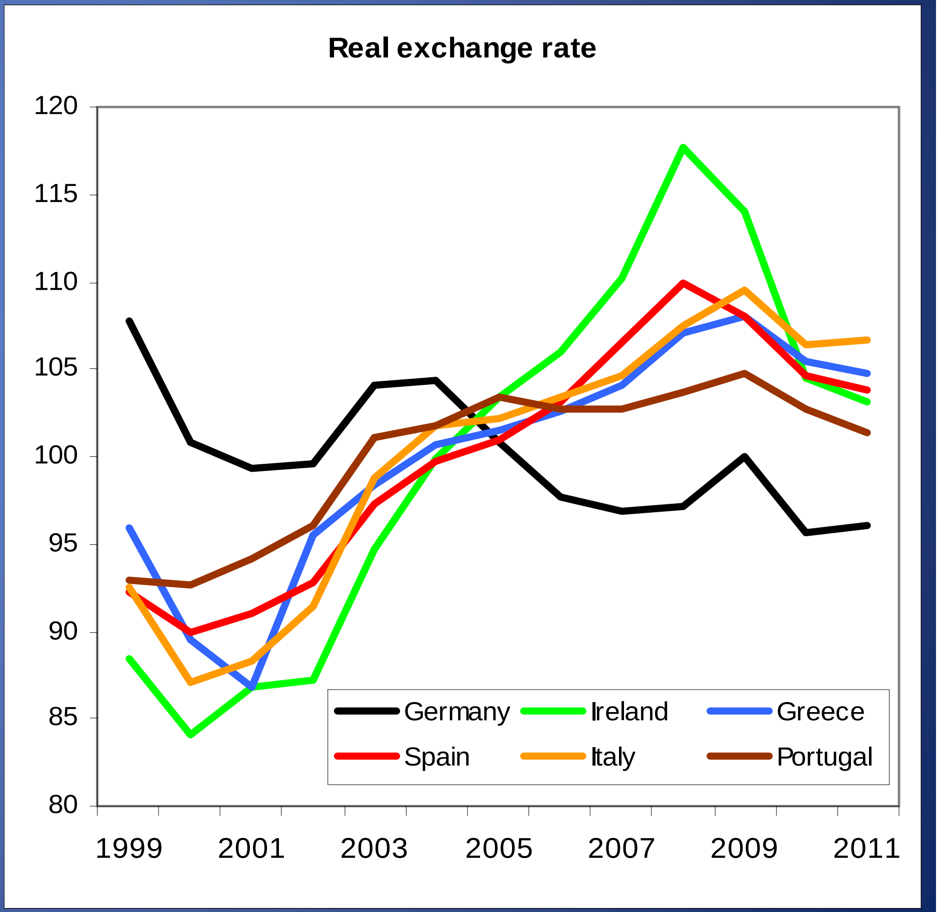
- Monetary policy setting quite different from 2000-07
  - Must stay behind activist fiscal policy – lower rates?
  - Leverage without credit growth – lean or clean?
  - Macroprudential will solve it - can we calibrate it?
  - Persistent positive price level shock – core still good?
  - Level vs stability of inflation expectations – rethinking price stability?
- Three objectives, three tools
  - Inflation expectations – interest rates
  - Liquidity preference – composition of balance sheet
  - Risk aversion - communication on path of rates

Thank you for your attention

Additional slides

Two ways of looking at REER





Source: Wyplosz, 2011

How does it change monetary policy

- 2000-07: low public debt
  - Information Technology
  - Globalization
  - Inflation Targeting

Downward pressure on goods prices and wages

  - Demographics => shift to DC pensions
  - EM post 1997 => self insurance
  - Asset shortages in EM

Upward pressure on AAA assets
Depressed risk aversion

  - Inflation targeting
  - Simple Monetary Policy => just rates
  - Clean, not lean
  - Passive fiscal policy

Increase in private credit/leverage

How does it change monetary policy

- 2010- ??: high public debt
  - Commodities boom
  - China hitting Lewis limit
  - Inflation Targeting

Upward pressure on goods prices, downward pressure on wages

  - Demographics => burst of entitlement bubble
  - Fiscal revenues bust
  - Financial sector rescues
  - Politics of default

Upward pressure on public debt
Tail risk fear

  - Inflation targeting???
  - Simple Monetary Policy => just rates???
  - Clean, not lean???
  - Active fiscal policy

Monetary policy becomes very complex and activist