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MR. SCHÄUBLE'S ULTIMATE WEAPON: The Automatic Restructuring of Public Debt

Carlo Bastasin

A GERMAN PLAN for revamping the euro-area proposes an automatic mechanism for sovereign debt-restructuring. This mechanism, designed by Berlin's Ministry of Finance, is designed to prevent any form of risk-sharing between euro-area countries and to confine the costs of fiscal and financial instability primarily within the more fragile countries. From the perspective of debt defaults, the plan could enforce more discipline, but it also risks dramatizing any future episode of financial instability.

The 18 countries sharing the euro are still struggling to recover from seven years of financial troubles that have jeopardized the very survival of the common currency. Since 2010, a slew of different proposals have been put forward for improving either the centralization of the area's economic governance or, alternatively, for decentralizing the risks and limiting the amount of risk-sharing. The German government seems to have lost faith in any form of centralized governance, and it would rather try to shield German taxpayers from sharing the potential costs of a sovereign debt crisis in other countries.

The plan is described in a letter sent at the end of November by the Ministry of Finance to the heads of the Finance and Budget Committee of the German Parliament. The unpublished missive prescribes an automatic mechanism for restructuring the public debt of any country requesting financial assistance. Once a country asks for help through the European Stability Mechanism (the ad hoc fund established in 2012), for whichever reason, sovereign bond maturities will automatically be lengthened, reducing the market value of those bonds and causing severe losses for all bondholders.

The mechanism would turn euro-area sovereign bonds into riskier assets—the goal of another proposal by the German government, which scraps the regulatory exception for sovereign bonds that allows banks to hold them without hoarding capital reserves to cover eventual losses. According to a rather abstract interpretation of how European economies work, making sovereign bonds explicitly riskier encourages banks and households to refrain from underwriting them too lightly. Governments will have fewer incentives to pile up debt. Banks will also turn away from investing in government bonds and perhaps engage more intensely with the real economy. Economic efficiency across the euro area should increase.

Unfortunately, establishing an automatic mechanism for sanctioning undesirable financial predicaments could also make them more likely to happen. Sovereign bonds have a unique and pivotal role for the financial systems of the euro-area. So, once sovereign bonds in some euro-area countries become more risky, the whole financial system might turn frail, affecting growth and economic stability. Ultimately, rather than exerting sound discipline on some member states, the new regime could widen bond rate differentials and make debt convergence simply unattainable, increasing the probability of a euro-area break-up.

Berlin's plan sides with the idea that crisis containment is only the problem of the more affected countries. It is also based on the assumption that any form of risk-sharing provides governments with the wrong incentives, creating a moral hazard. However, as the crisis has shown, financial vulnerability can have a non-fiscal origin or result from common problems, and sanctioning individual countries can make instability more likely to degenerate into an outright crisis.

The German government's document shows a rather fundamental mistrust of the fiscal attitudes of other governments. Repeated application of ”flexibility clauses” to subtract special purpose expenditures from the deficit is raising eyebrows in Berlin. Brussels' limited success at keeping national budgets under check is considered a problem. The German government holds the EU Commission in contempt, deeming it too exposed to political blackmail by national governments, especially with concern over anti-European and populist movements mounting. In the past few years, crisis-mismanagement has made centralized fiscal governance less appealing for the other euro-area countries as well. Asymmetric rule application, untimely decisions, and the favoring of ”creditors' law” over common interests and ideological biases have tarnished the trust in common decisions. National governments, each in their own way, are turning from timid risk-sharing to embrace outright risk decentralization as the one and only way to manage a monetary union.

Looking at the threat of debt-restructuring as an effective policy discipline, Berlin asks that government bonds lose their status as non-risk assets. This "regulatory exception" makes banks accumulate sovereign bonds in their balance sheets without the need to increase their own capital. In the document sent to the Bundestag, the Finance Ministry proposes that the euro-area preempt international regulators in acknowledging the specific riskiness of sovereign bonds. Once it is established that government bonds bear risks like all other assets, banks will be encouraged to reduce the amount held, breaking the vicious cycle that has characterized the crisis, with public debt financing woes endangering bank stability and vice versa. According to Berlin's document, the euro-area countries should also permanently reduce their debt-to-GDP levels. To achieve it, Berlin wants to prevent each country from invoking flexibility clauses. In particular, the Italian request for flexibility showed marked weakness on the Commission's part during negotiations. France did not even bother to obtain authorization for its indulgent fiscal policies. In talks with euro-area prime ministers, EU Commission President Juncker was forced to choose between authorizing incumbent governments to widen their deficits for a myriad of reasons, and fostering anti-European populist movements that want to scupper the entire monetary union. This precise weakness in the coordination of centralized budgetary policies has convinced the German authorities to call for decentralized risks and depoliticized controls.

"The oversight role of the Commission"—says the document authored by the Finance Ministry—"should not be limited by political tasks." To make Brussels' judgment independent through political convenience, Berlin aims to separate the supervisory functions performed by the Commission from its role in policy orientation. Alternatively, control over fiscal policies

could be handed to new independent and technocratic institutions. If these mechanisms still fail to rein in public debt, then the threat of an easy way to restructure debt will do the trick: markets will become oversensitive to fiscal indiscipline and punish what politics forgives.