Discussion of

What is the risk of European sovereign debt defaults?

(J.Aizenman, M.Hutchinson, Y.Jinjarak)

by

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New Delhi, 15-16 March 2012

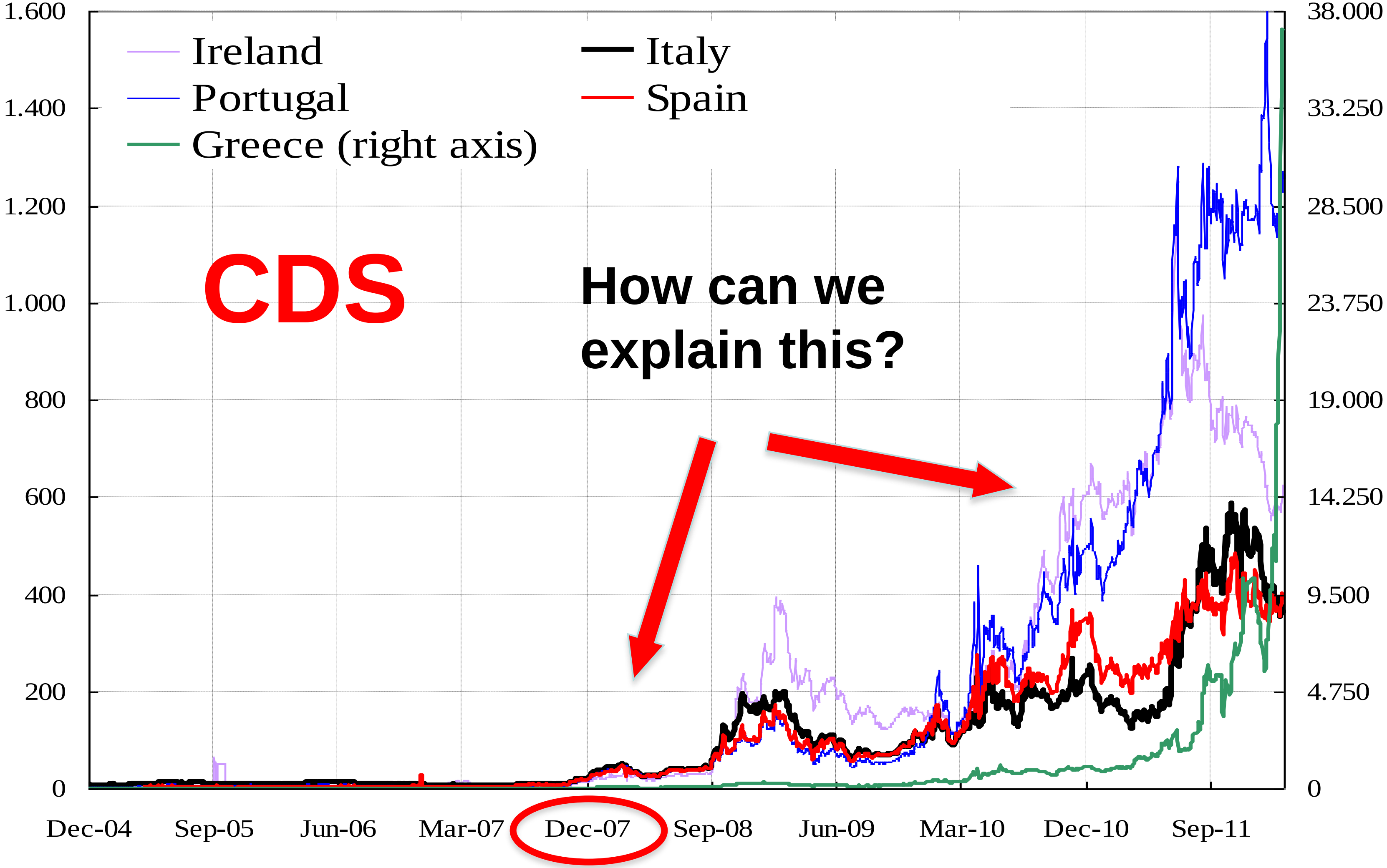
Ouline

- Summary of the paper approach & results
- Some comments on the “take home” of the paper
- Some thoughts on the sovereign crisis focusing on Italy

Section 1

SUMMARY OF RESULTS

Main theme of the paper



Summary #1: approach

- *Explaining pricing of sovereign risk*: use 2005-10 data on 5-yrs maturity CDS of 60 countries and propose model:

$$CDS_t^j = \alpha^j + \lambda_t + \gamma \Delta CDS_{t-1}^j + FS_t^j \beta + Z_t^j \delta + u_t^j$$

Fiscal space

- *Estimation*: various periods and methods (FE, GMM):
  - Results **vary across samples and methods**
  - Evidence on **SWEAP is puzzling (no explanation)**

Summary #2: warning signs

- *Decoupling*: fiscal space is highly significant for CDS. But it is no longer so in the "crisis years"
- *Loss in explanatory power*: the model explains up to 80% of CDS spreads before the crisis, less than 60% during it.
- Authors offer 2 possible explanations:
  - Mispricing
  - Focus on future "fiscal developments" not reflected in current data

Section 2

REMARKS ON RESULTS

Comments #1: loss of explanatory power

- ***Global factor*:** During the crisis the global price of risk went up (as a consequence of deleveraging, toxic assets and so forth). Does the **model miss a global factor**?

For example: Bernoth, *et al* (2004) show that yield spreads are affected by international risk factors and reflect positive default as well as liquidity premia.

Comments #2: volatility / contagion

•***Volatility*:** During the crisis CDS have been highly volatile. But the model has no measure for it:

→ try *VIX*, *VSTOXX* to capture sudden **changes in risk appetite**?

• ***Contagion*:** Indicators of spill-over effects might help explaining widening spreads in group of countries (see Segoviano and Goodhart, 2009 and Caceres, Guzzo Segoviano, 2010)

Comments #3: structural break?

- ***Break:*** Determinants can change btw *crisis* and *non crisis* periods

For example: **Ebner (2009)** *finds* **significant differences** *in government bond spreads in Central and Eastern Europe during* ***crisis and noncrisis periods****. During crisis periods,* macroeconomic variables lose some of their importance and other factors *become more relevant: market volatility*, *political instability or uncertainty*

Comments #4: current vs future

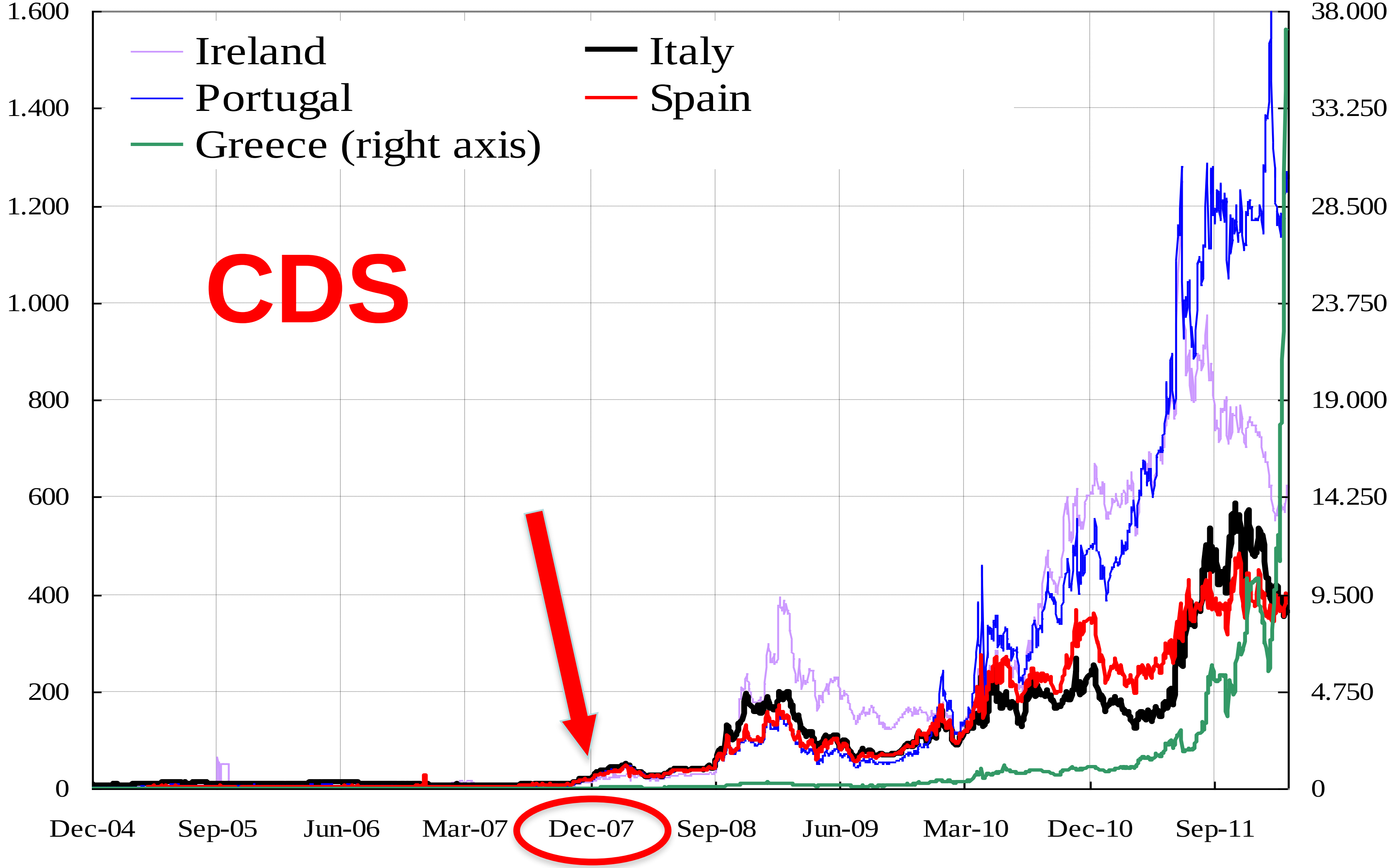
- ***Forward looking*:** there is indeed little action in current developments in “fundamentals” to explain huge surge in risk price, especially in SWEAP… but some remedies are easy to implement:

- IMF GDP and Fiscal projection;
- CF forecasts
- …

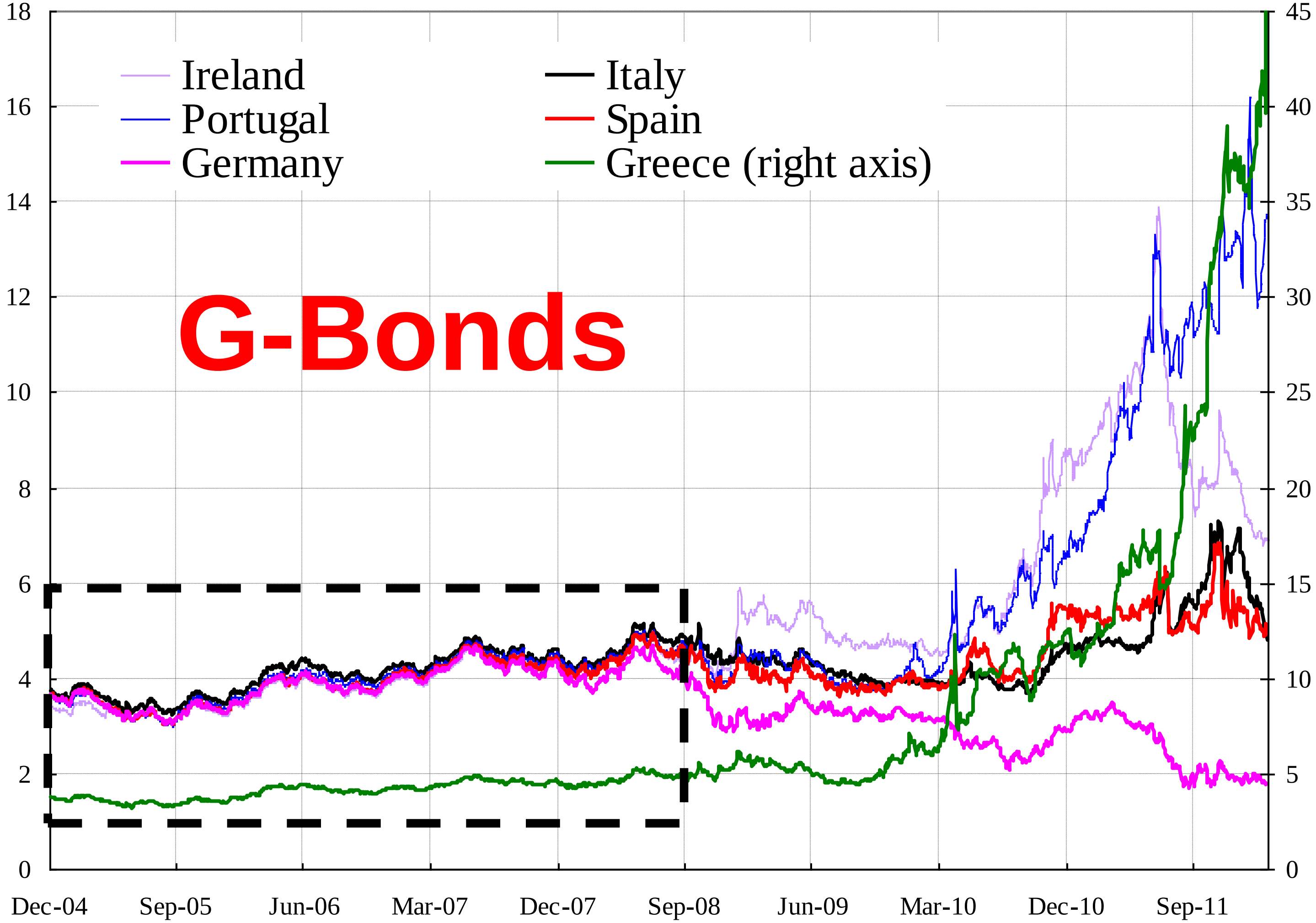
Section 3

IRRATIONAL MARKETS? THE CASE OF ITALY

Risk priced equally in EA up to 2007



Risk priced equally in EA up to 2007



Italy:

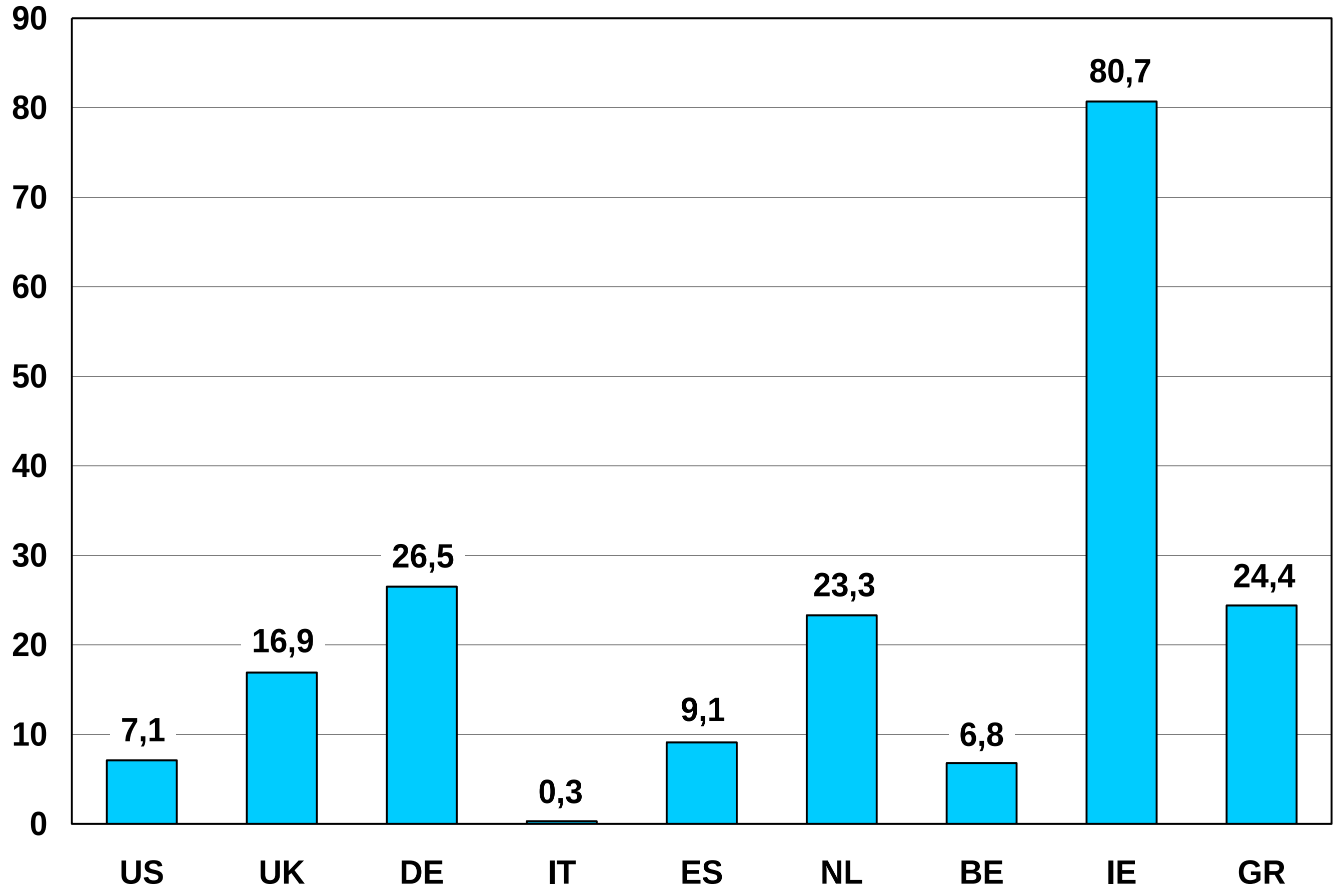
- ***Fiscal situation*:**

Before the sovereign debt crisis Italian fiscal position was better compared with that of many EA countries: in particular, with then prevailing interest rates and growth perspectives (1%) the DEB/GDP ratio was expected to decline.

Then the crisis arrived…

Banks did not require any significant support

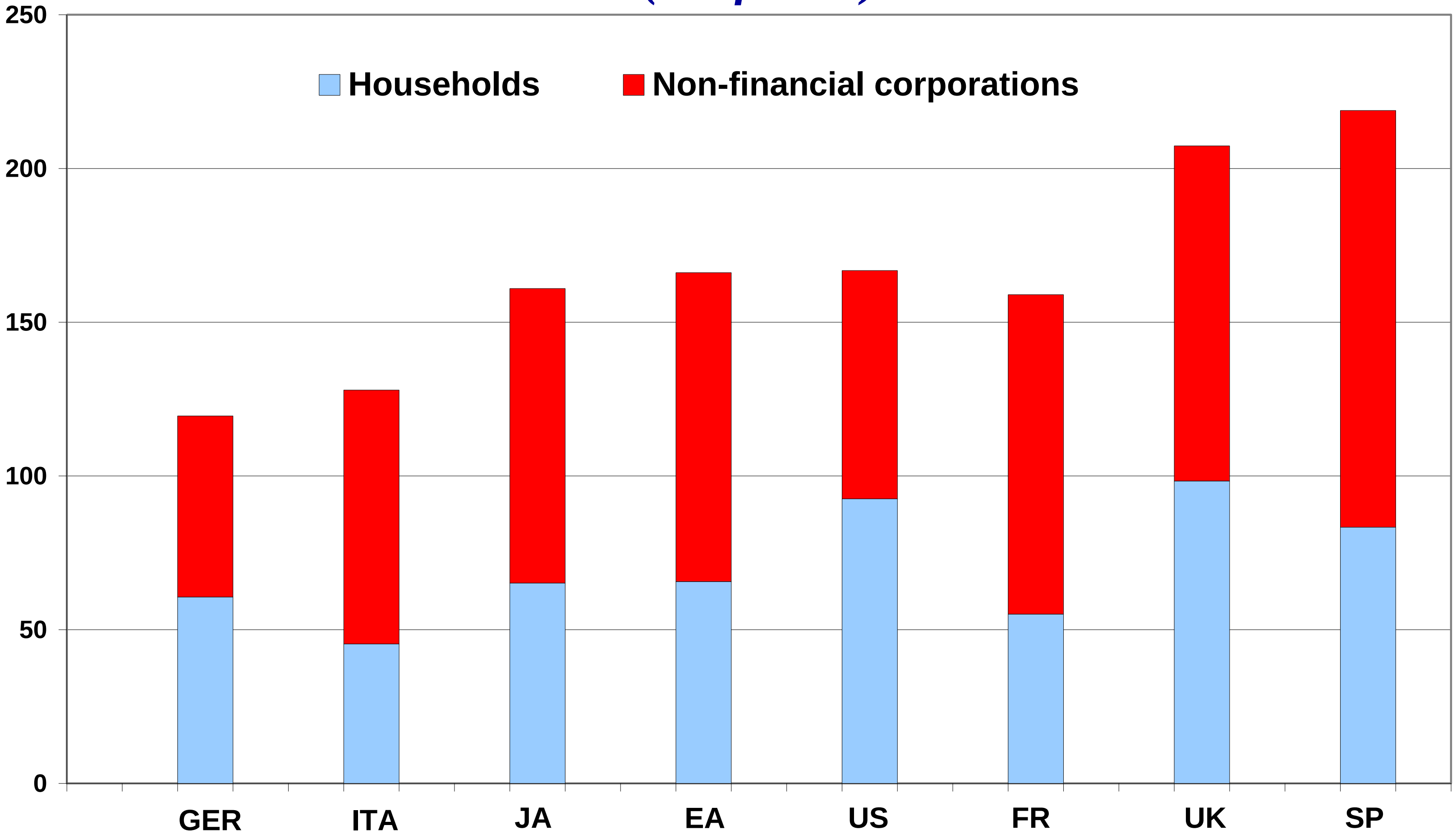
Government support to the financial sector (1)
(as a percentage of 2011 GDP)



Source: based on IMF (*Fiscal Monitor*, September 2011) and Bloomberg.
(1) For each country, the sum of direct support (actual outlays on capital injections and purchases of assets) and cumulated issuance of guaranteed bank bonds.

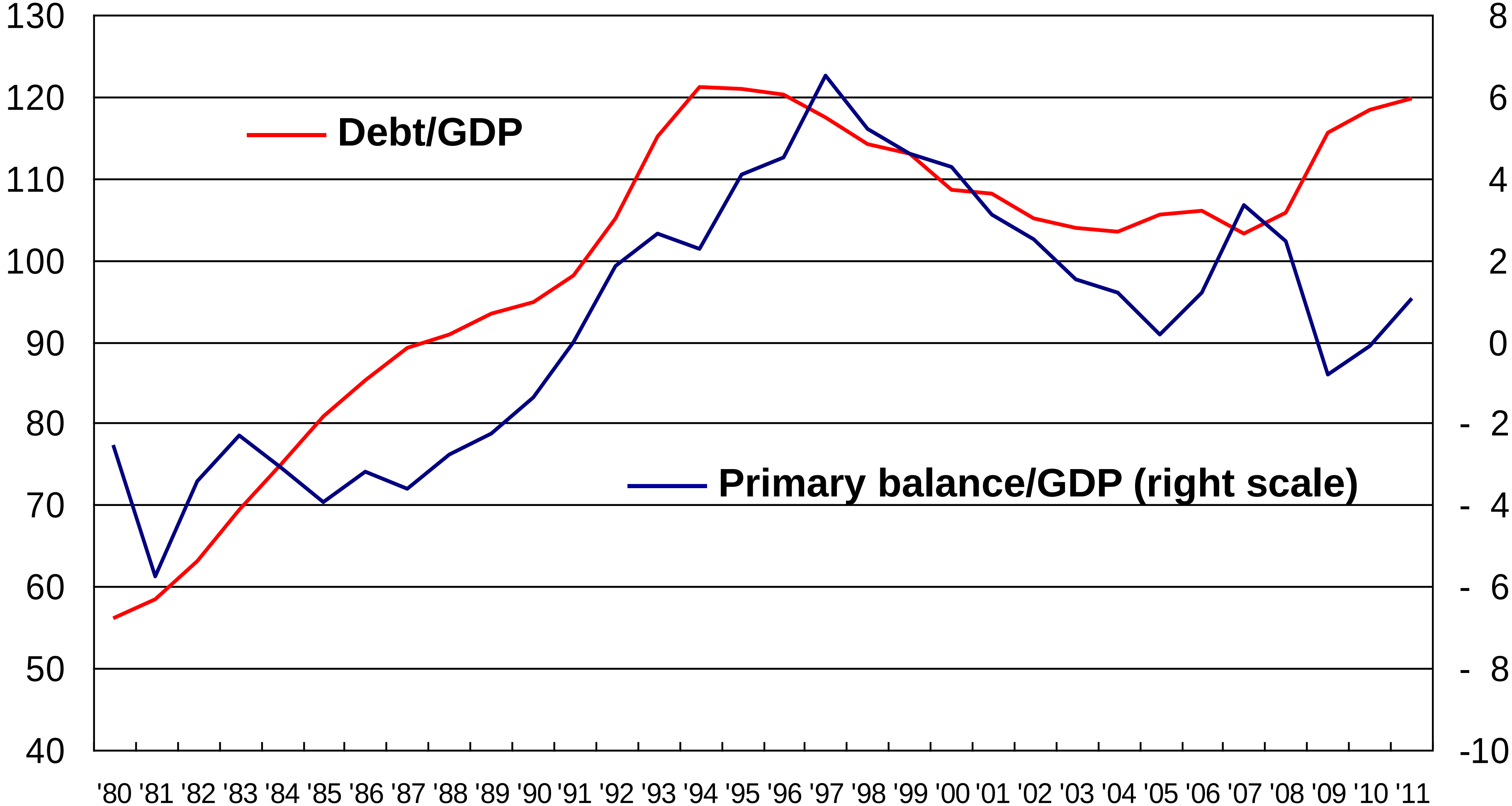
The financial debt of households and firms is relatively small (1)

(% of GDP)



(1) Data as of 2011 Q1 (for Japan, 2010 Q4).

So Italy is not guilty? … Missed opportunity to reach a safer debt ratio before the crisis



Fiscal policy after the sovereign crisis started spreading **:**

- Prudence during the crisis

  (**Between 2007 and 2010 the ratio of general government net borrowing to GDP rose by 3.1 p.p. in Italy and by 5.3 p.p. in the euro area**)

- Major consolidation in successive policy moves since last summer

… a sizeable structural adjustment for 2012-2014

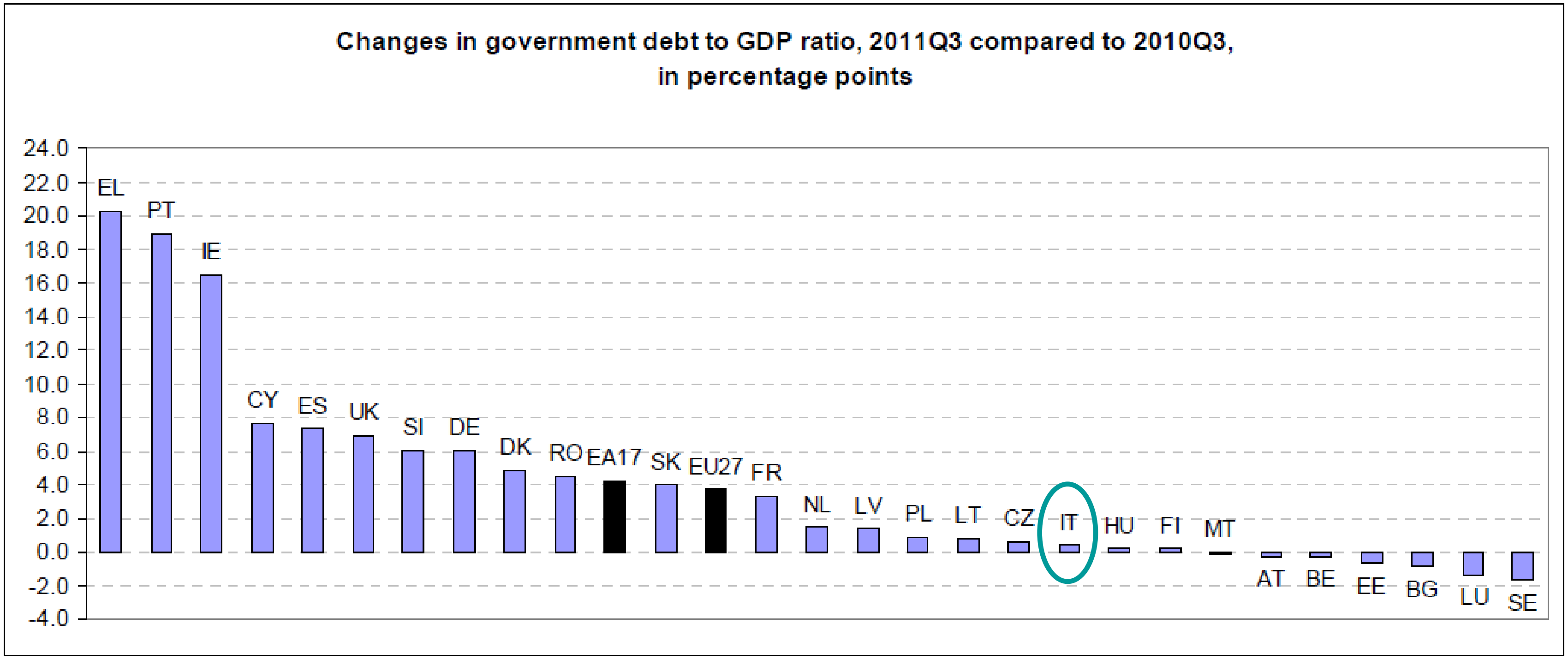
In the second half of 2011, Italy introduced 3 fiscal packages amounting to nearly 5 p.p. of GDP with the aim of balancing the budget in 2013

They are going to set the debt ratio on a declining path even in adverse conditions.

The pension reform process has been completed

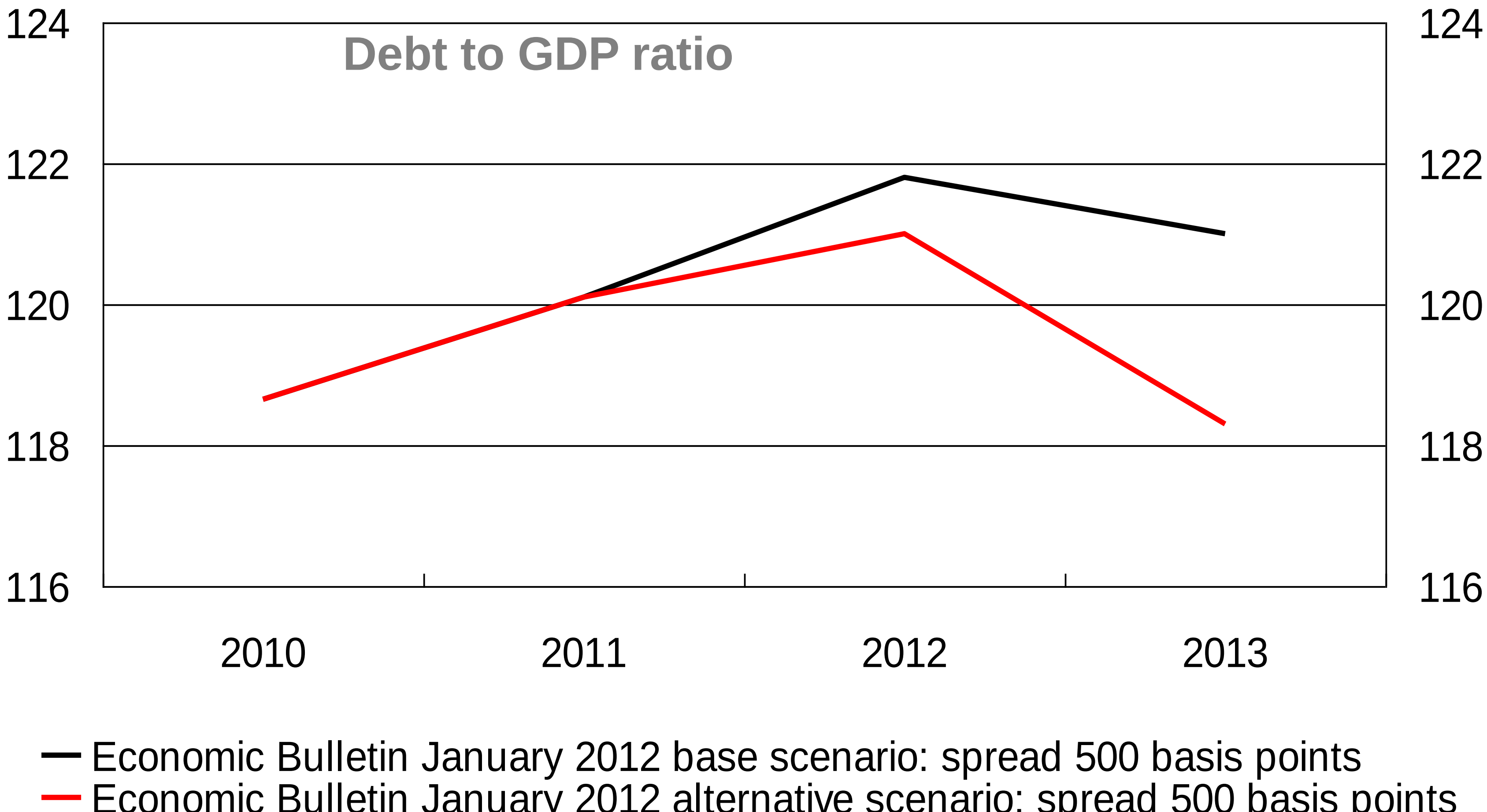
… the outturn for 2011 was in line with targets …

- **General government net borrowing decreased from 4.6 per cent of GDP in 2010 to 3.9 per cent in 2011.**
  - o sharp fall in the ratio of primary expenditure to GDP by about 1 p.p (from 46.6%) more than compensates the increase in interest payments
  - o stable revenue ratio
  - o debt-to-GDP ratio rose to slightly above 120 per cent (increase smaller than the average of Euro area)

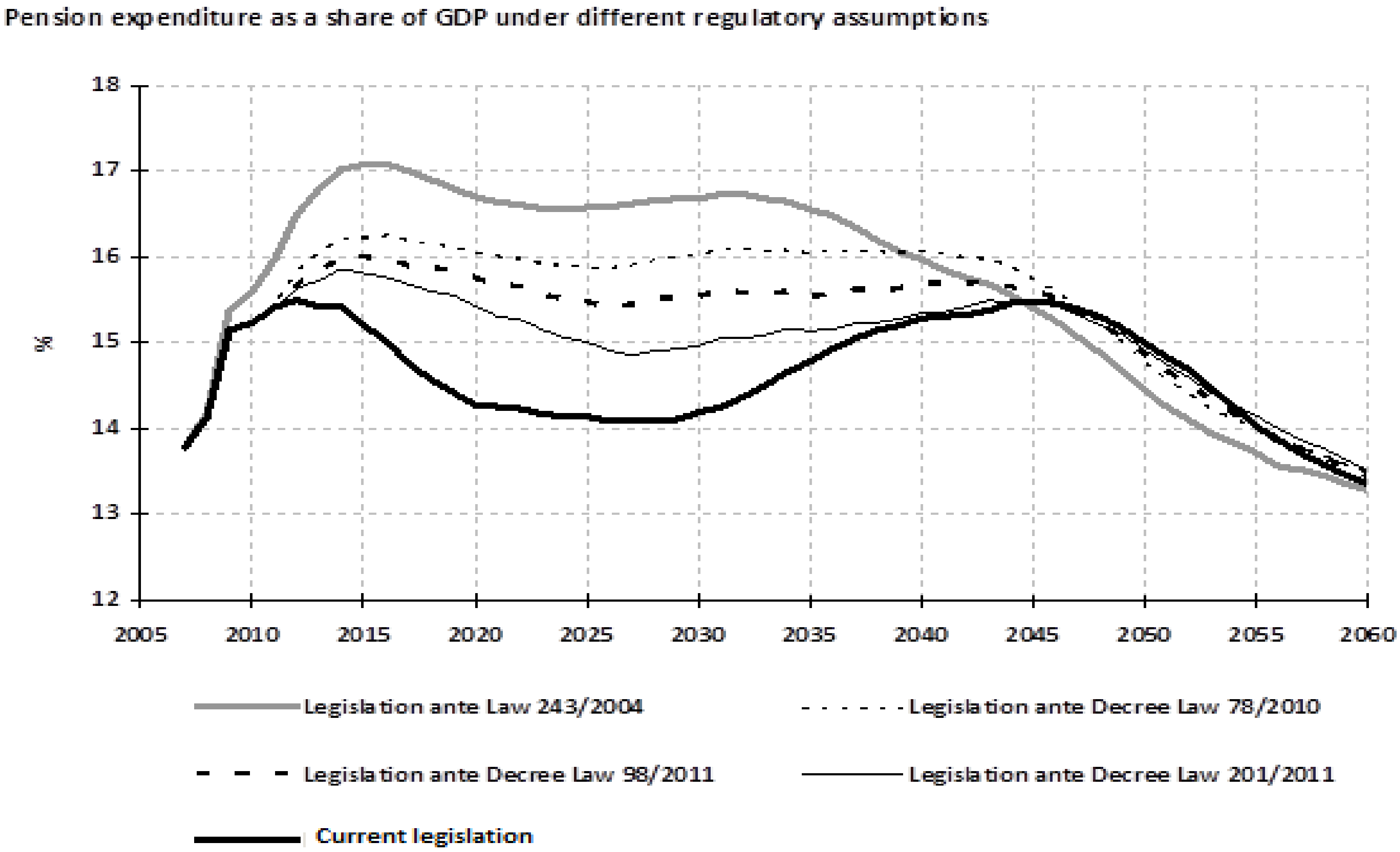


Debt is sustainable

With a primary surplus of 5% debt will be on a declining path from 2013 even assuming 500 b.p. spread (about 200 b.p. higher than current levels)



Pension expenditure will decline over the next 15 years



Source: Ministero dell'Economia e delle Finanze,
***A strategy for fiscal consolidation, growth and social fairness*, January 2012**

So how can we explain Italy "case"?

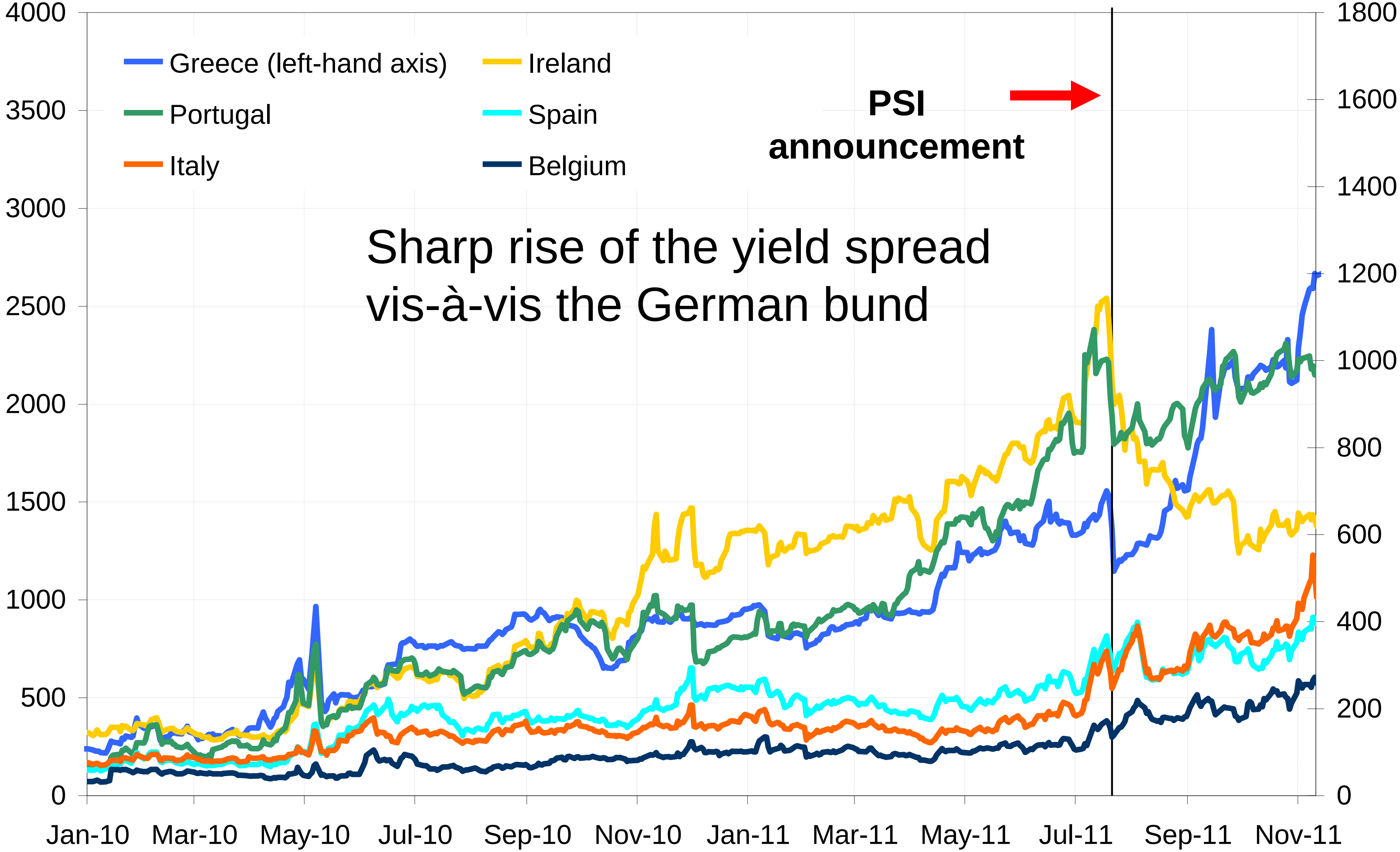
- High **DEBT/GDP** compounded with liquidity problems in the mkts triggered a reaction

- A **political process** started with some **delay** … and the Government changed.

- While <u>public finances are stable</u>, **growth prospects** are still **weak** ➔ structural reforms

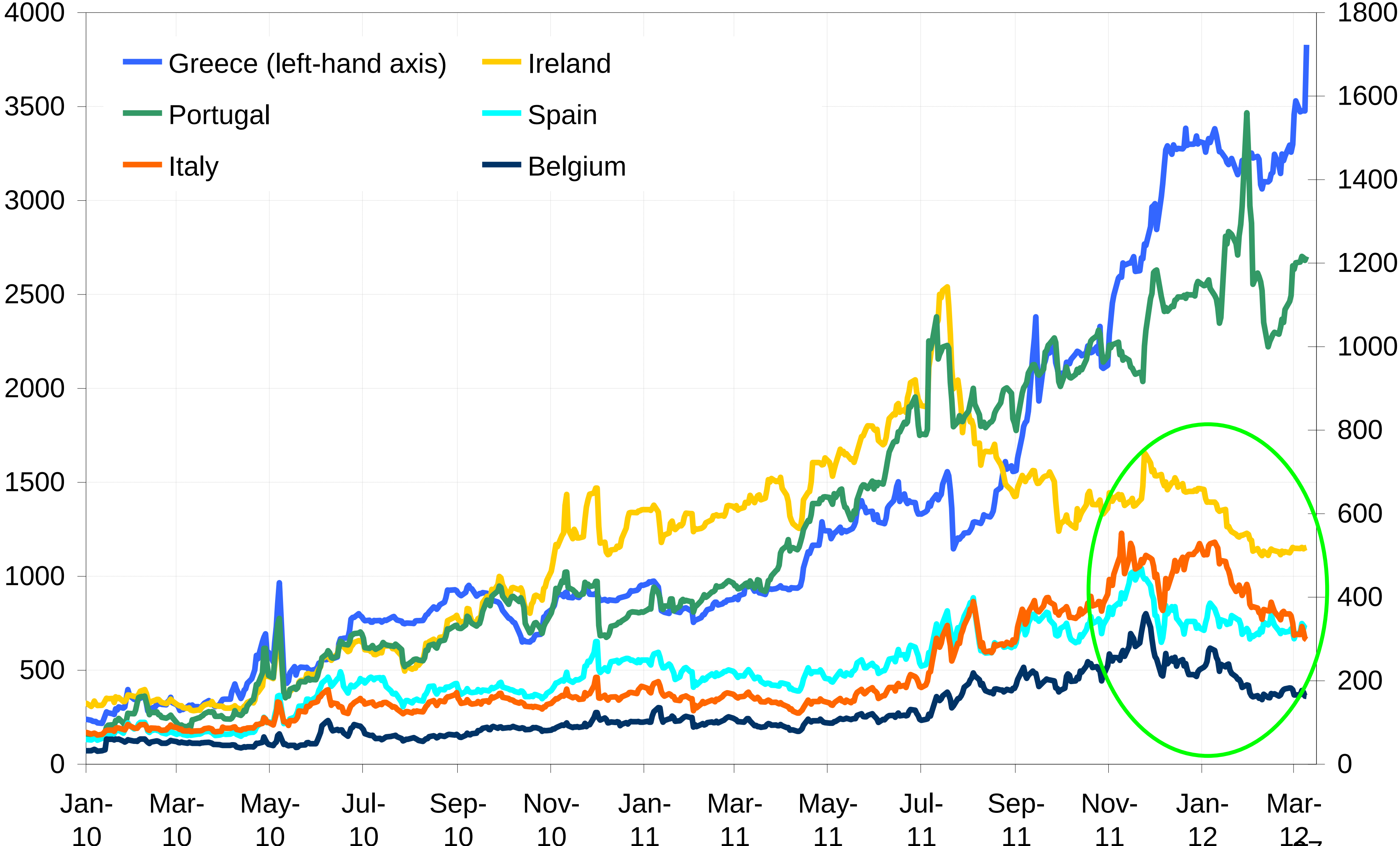
- There are still *spill-overs* from the **European political process** (firewalls, PSI, adequacy of the lending capacity of EFSF/ESM).

A European problem…

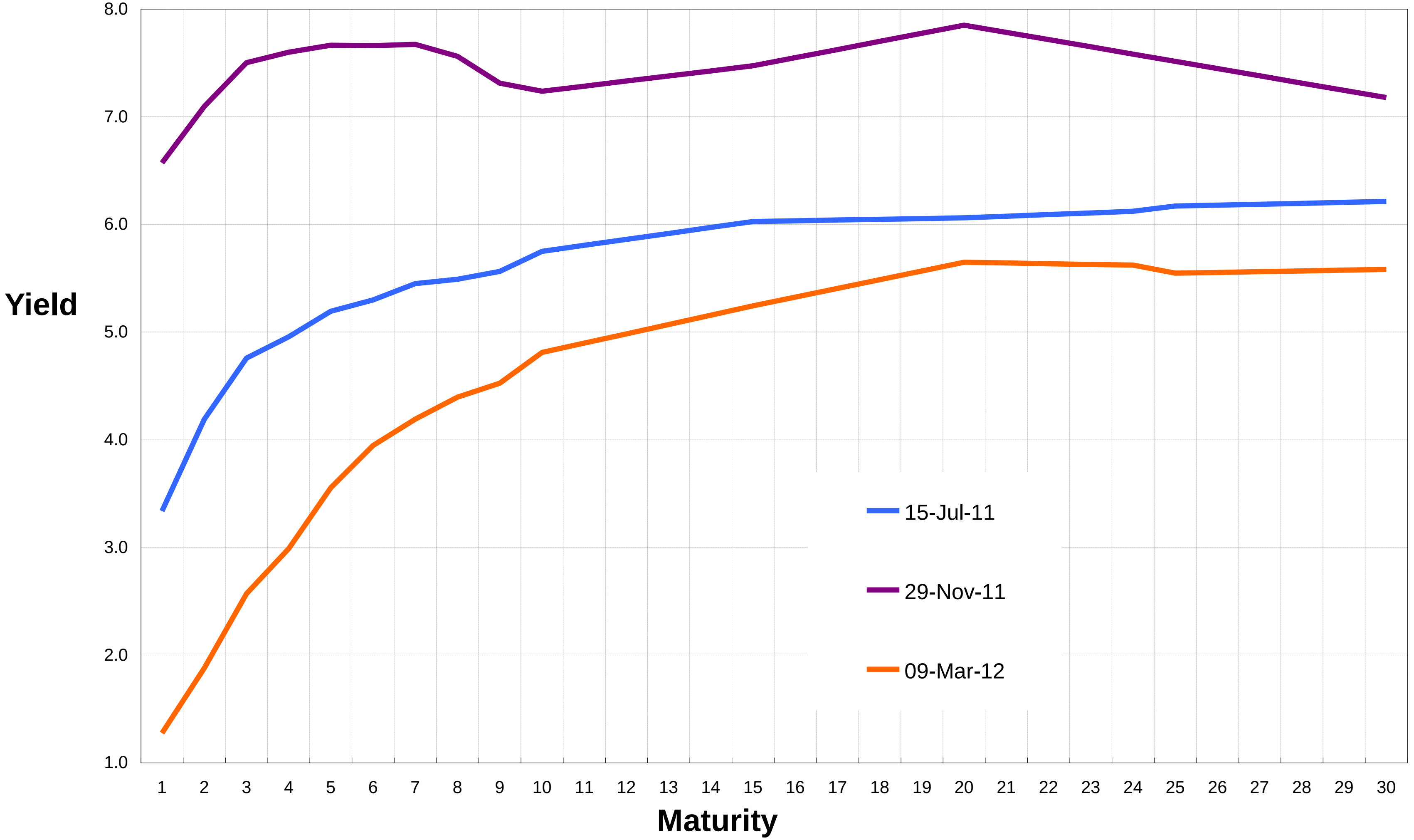


SO …
IRRATIONAL MARKETS?

The yield spread vis-à-vis the German bund is narrowing



Italian sovereign bonds yield curve



IRRATIONAL MARKETS?

A CORRECTION IS UNDERWAY, SO POLICIES AND FUNDAMENTALS OBVIOUSLY MATTER …

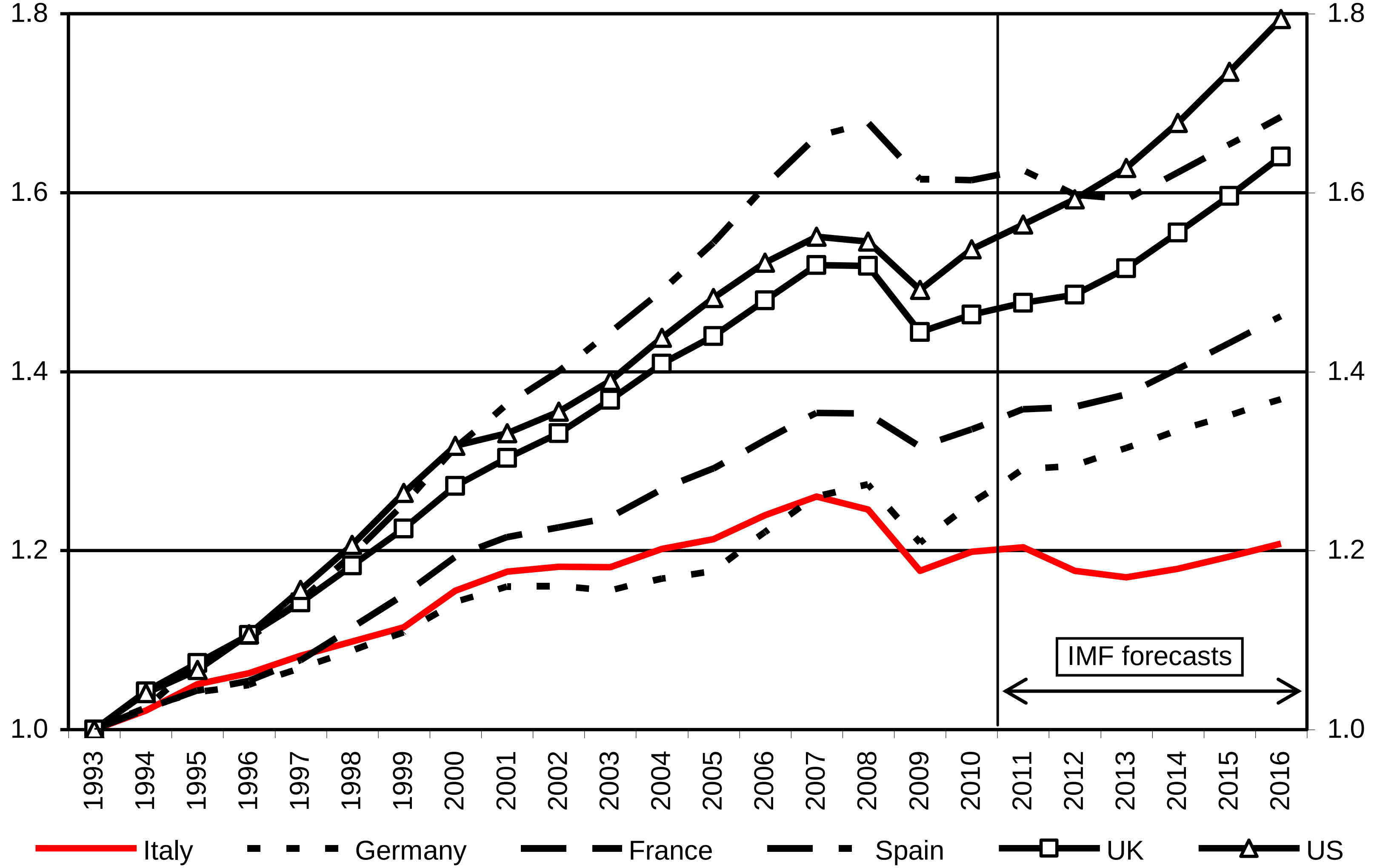
but

PROBABLY FOR SOME TIME "IRRATIONAL" OR EXTREME MARKET REACTIONS WILL BE WITH US.

T H A N K S

Italy scored a poor growth performance in the last two decades…

GDP (constant prices, 1993=1)



An ambitious plan for structural reforms is underway

- **Starting with the fiscal packages in July and August 2011, a number of measures have been adopted concerning**
  - ***Innovation and firm growth***
  - ***Competition and liberalization***
    - professional services
    - retail sector
    - network infrastructures
    - local public services
    - powers of antitrust authority
  - ***Doing business environment***
    - business start-up
    - territorial organization of courts

- **Other actions (also in other sectors) to be taken**
  - ***Labour market, education, ICT***

Decisive action by the ECB

- **Dec 2011: in addition to further official rate reduction, broadening of non-standard measures**
  - 3-year refinancing operations
  - expansion of the range of assets eligible as collateral
  - halved compulsory reserve coefficient
- **3-year LTROs on Dec 21 and Feb 29**
- **New collateral requirements are conservative**
- **Large collateral pool of Italian banks**

At the EU level: agreement on fiscal compact and PSI

- **Fiscal Compact (January 2012)**
  - Balanced budget in national legislation (possibly Constitutions, including provisions for automatic correction of slippages;
  - European Court of Justice to judge national compliance;
  - reversed qualified majority voting to approve EC recommendations
  - Confirms provisions of the six-pack (including the cap on expenditure growth and the minimum requirement for debt reduction)

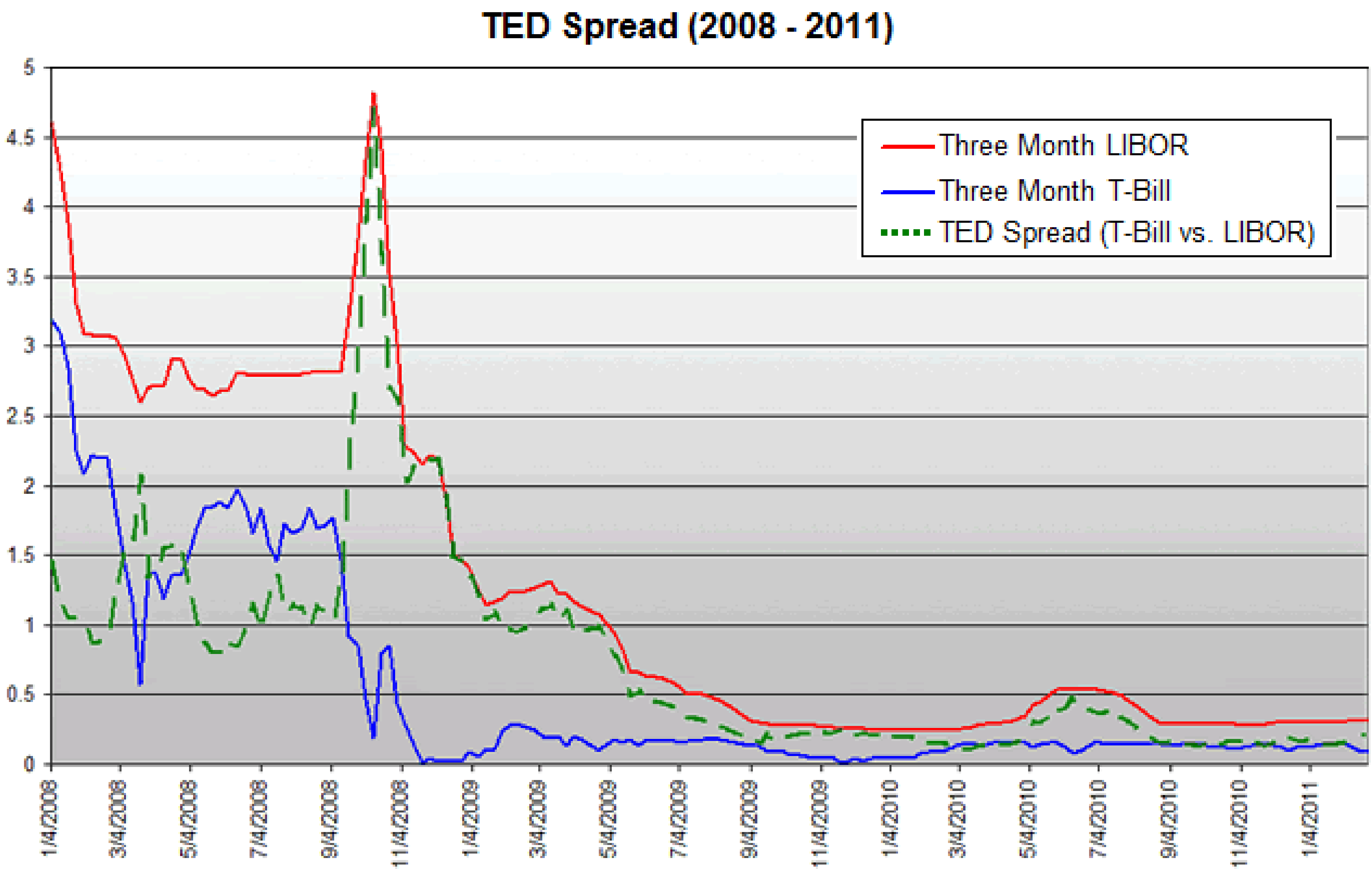
- **Greek PSI (February 2012)**
  - Eurogroup confirmed additional EFSF financing (up to €130bn until 2014)
  - Conditional on successful voluntary bond exchange with private creditors
  - The outcome of the exchange offer last week was favourable

Exiting from the emergency in the euro area

- **ECB non-standard policy measures were decided upon under exceptional circumstances and are therefore temporary in nature**
- **The 3-year LTROs are no exception**
- **They have reduced drastically the risk environment, but the full unfolding of their effects, especially on credit, will take time; we will carefully monitor and assess the developments**
- **Monetary policy cannot do everything**
  - adequate firewalls must be in place to shelter financially fragile sovereigns
  - governments must complete fiscal consolidation and structural reforms, thereby eradicating the chief cause of the crisis and of difficulties in the banking system
  - banks have to improve their resilience to shocks

GREEK CDS


Print
25000
20000
15000
10000
5000
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
2012
FEB
MAR


TED Spread (2008 - 2011)
Three Month LIBOR
Three Month T-Bill
TED Spread (T-Bill vs. LIBOR)
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
1/4/2008
3/4/2008
5/4/2008
7/4/2008
9/4/2008
11/4/2008
1/4/2009
3/4/2009
5/4/2009
7/4/2009
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