The Great Financial Crisis
Ways out of debt

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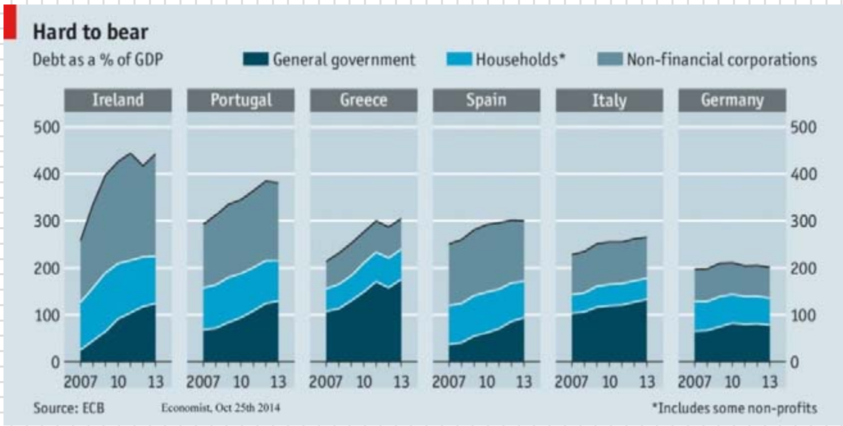
Source
Brasche, U. (2014). Debt-overhang and ways out. Brandenburg

Overview

- **Legacy debt still increasing**
- **Sustainability of debt – the factors**
- **Ways out of debt**
  - Overview
  - Focus: „Austerity or growth“
- **Is there a way out?**
  - Four scenarios

Debt
Increase after 2007



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Debt
Sovereigns

Economist, Oct 14th, 2010

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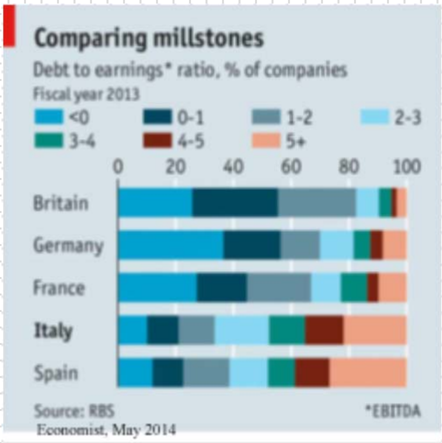
Debt Companies



Debt sustainability

Ways out of debt
Overview

- Buying time
- Make credit accessible (again)
  - IMF, ESM, Euro-Bonds, ECB as „lender of last resort“
- Decrease debt levels
  - Budget surplus, privatisation, capital levy, financial repression, debt-to-equity swap, haircut
- Decrease debt service
  - Interest rate down, extended maturity
- Inflate debt away
  - Presently **de**flation
- Export surplus
- Mutualisation of debt
- Austerity and / or growth

Ways out of debt
Austerity and / or fiscal stimuls

- Timing: Consolidation or stimulus first?
  - "Expansionary austerity" doesn´t happen
- Is Keynes still the master?
  - Size of stimulus and lack of credit
    - Greece before crisis: 4% EU + 15% deficit as "new normal"
  - Lack of and/or obsolete capacity
    - Spanish and Irish construction industry
    - British financial industry
    - Business model of Greece beyond tourism and agriculture
  - Deficient institutions
    - Corruption, administrative capacity
    - Vested interests, rent seeking
  - Debt-deleverage and balance sheet recessions (I. Fisher, 1934; R. Koo, 2008; S. Keen, 2010)
    - Repair balance sheet from surplus – less demand

Current situation

- The Euro-Zone still is in crisis
  - Slow growth
  - High and increasing debt
- Legacy debt is not covered by various proposals
- Collapse is postponed by
  - A flood of cheap ECB-credit
  - OMT promise
- Structural issues unsolved
  - Economic business models of crisis countries not sufficient
  - Institutional weaknesses prevail
  - Moral hazard and common pool problem
  - „Bank-sovereign doom loop“ still existing

Is there a way out?
Four scenarios

- Scenarios
  1. Chronic prolongation
  2. Clean slate
  3. Shock and collapse
  4. Full solidarity

Scenario
1. Chronic prolongation

- Debt grows rapidly worldwide
- monetary policy of cheap credit
  - cheap credit can´t be absorb for productive projects
- growth stays weak in most countries
- Debt-to-GDP ratio deteriorates further
- The next bubble is building up
- Social unrest and tension in societies increase
- Frustration feeds into international conflicts with the "enemy outside"

Scenario
2. Clean slate

- Drastic haircut
  - To end debt-deleverage
    - sovereigns, private households and companies
  - To repair balance sheets of banks
- Type of haircut
  - ´elegant´
    - shifting debt from private into public purses (ECB, ESM, …)
    - prolongation of debt to eternity
  - Direct
    - "private sector involvement" with Collective Action Clause
  - Open issue: Are public creditors allowed to forgive debt??
- Creditors bleeding
  - Middle class in "North" (private retirement)
  - A few banks will close
- Many of today´s financial assets are worthless
- Hope: Short-time turbulences – growth picks up again

Scenario
3. Shock and collapse

- **A single event triggers**
  - fear and contagion
    - ECJ ruling against ECB´s OMT-policy ➔ spreads explode
    - collapse of the (financial) system
- **Prolonged recession and / or radical parties winning elections**
  - No more payment obligations honoured
  - Depreciation, banks collapsing
- **Break-up of the EU**
  - Elections
    - UKIP wins in UK
  - Separatist movements
    - Scotland – II
    - Catalunia

Scenario
4. Full solidarity

- **Mutualisation of**
  - Legacy debt
  - Future access to credit
  - Loss of competitiveness in „north"
- **Fiscal Union**
  - Substantial transfer of power to a supranational level
    - Fiscal Union
    - United States of Europe
  - Taxation and spending decided in Brussels
  - Massive re-distribution from „north" to „south"
    - Transfer-Union
- **Top-Down Revolution**
  - Deepening is not accepted by the peoples of EU – at least not now
  - "European elites" pushing - reaction of wider public is uncertain