

Box 5

PRIVATE SECTOR INVOLVEMENT AND ITS FINANCIAL STABILITY IMPLICATIONS

Private sector involvement (PSI)¹ has occasionally been used in the past in the resolution of sovereign debt crises. It was intended to help sovereign borrowers to regain fiscal sustainability more rapidly than would otherwise have been the case, and it was generally considered as a measure to ensure burden-sharing between the public and private sectors. Lenders who have financed fiscally irresponsible countries thus bear the consequences of their decisions. In addition, the need for official financial assistance may be reduced.

However, this box argues that past experiences with PSI applied to countries that were not part of a monetary union are not comparable and thus do not provide reliable guidance. Within a monetary union, financial markets are very closely integrated, and the negative economic impact of PSI is therefore much more extensive. The application of PSI to one member country may put at risk the financial stability of the currency area as a whole.

First, PSI can be expected to have direct negative effects on the banking sector across the euro area. While PSI is certain to place significant stress on the solvency of banks and other private financial institutions in the country concerned, it will also have an impact on the balance sheets of banks in other euro area countries through cross-border sovereign bond holdings, cross-shareholdings, funding or branch channels. This could trigger a need for large-scale bank recapitalisation.

Second, contagion across the euro area can occur via confidence effects. If the application of PSI in one member country leads to a sudden increase in risk aversion among financial market participants, the market access of other countries may be hampered. This may occur even if the economic fundamentals of the other countries remain unchanged as compared with the situation prevailing before the application of PSI.

These two channels of contagion are likely to be mutually reinforcing. Bank recapitalisation may have to be borne in part by the public sector, weighing on the sustainability of public finances. Additional strain on the public finances of already vulnerable euro area countries could lead to a deterioration in the credit ratings of those countries, which, in turn, would increase funding stress also for banks. This would further weaken the prospects of the banking system and increase the recapitalisation requirements of financial institutions.

¹ The term “private sector involvement” is generally understood to refer to measures to “bail in” private creditors in the context of the resolution of a sovereign debt crisis. Measures may include rescheduling/reprofiling and restructuring. It is generally of a voluntary nature and the result of a collaborative approach between borrowers and lenders. For details, see *The IMF and the Private Sector*, Factsheet, IMF, Washington, D.C., August 2001.

PSI could also damage the reputation of the single currency internationally, possibly adding to volatility in foreign exchange markets. In particular, public and private international investors may be cautious about investing large portions of their wealth in assets denominated in a currency of sovereigns that may not fully honour their obligations and may be willing ex ante to rely on PSI in some circumstances.

Furthermore, the longer-term implications of PSI, particularly for the prevention of sovereign crises inside a monetary union, are not clear-cut. On the one hand, PSI is meant to exert a beneficial long-run effect by strengthening market discipline.² Creditors will have an incentive to closely monitor the sustainability of a sovereign's public finances and are likely to charge commensurate risk premia. This is an important mechanism through which to exert a disciplining effect on a sovereign. On the other hand, PSI may aggravate moral hazard with regard to the borrower. If a sovereign knows that it does not have to fully honour its contractual obligations and could instead restructure its debt, it may be tempted to accumulate excess levels of debt. Strengthened market discipline through higher risk premia is likely to be insufficient to counteract the sovereign's weakened incentives.

Against this background, the ECB has strongly advised against all concepts that are not purely voluntary or that have elements of compulsion, and has called for the avoidance of any credit events and selective default or default.³ All euro area governments need to demonstrate their inflexible determination to fully honour their own individual sovereign signature, which is a decisive element in ensuring financial stability in the euro area as a whole. The risks of PSI underline the importance of strong governance in a monetary union to ensure sound fiscal positions in all member countries at all times. They also emphasise the need to have an effective crisis resolution mechanism at the European level – the European Financial Stability Facility and, from mid-2013, the European Stability Mechanism – to ensure that financial assistance can be provided effectively and under strict conditionality should a euro area country experience problems in the future with obtaining refinancing in the markets.

² This beneficial impact prevails unless PSI requires financial participation incentives for creditors exceeding the cost of financial assistance in the absence of PSI.

³ See, for example, the introductory statement by Jean-Claude Trichet, President of the ECB, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament on 30 June 2011.