

TALKING ONE'S WAY OUT OF A DEBT CRISIS

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Abstract

The policy of Euro-area officialdom in the period 2010-2011 was to avoid, at all costs, a default and restructuring of the sovereign debt of a member of the monetary union. This policy was motivated principally, but not exclusively, by a fear that the international capital markets, if forcibly reminded of the precarious position of overindebted, growth-challenged members of a monetary union, might recoil generally from lending to European sovereigns. In short, they feared contagion.

The only alternative to permitting a debt restructuring, of course, was an official sector bailout. The afflicted countries -- Greece (until 2012), Portugal, Ireland and Cyprus -- received loans from official sector sources sufficient to allow them to repay in full their maturing bond indebtedness. Whenever and wherever the crisis erupted, contagion was thus held in check by the blunt technique of smothering the outbreak -- in money.

The proponents of this policy argued at the time, and argue now, that many European sovereigns in 2010 were far too fragile to endure a bout of market contagion. They argued that an acute crisis needed to be averted in order to buy time for the implementation of a gradual but more durable remedy. Had the intervening eight years been used to reduce the debt vulnerabilities of the peripheral (and even some core) states, this argument would now be powerful, indeed invincible.

Unfortunately, the opposite happened. Average state indebtedness in Europe today is about one-third larger than it was in 2008. Both the member states and the market saw the reprieve as spreading a reliable official sector safety net under their exposure. So they kept on borrowing

and lending. Only the zero interest rate policies of the world's major central banks during this period have kept debt servicing costs at tolerable levels.

Imagine a treaty creating a monetary union that expressly forbids the union from assuming unsustainable debts incurred by member states. Imagine further a central bank for the monetary union that is explicitly precluded from providing monetary financing directly to member countries. If a member becomes financially overextended, how can union officials jolly the markets into continuing to lend to the country in order to stave off a debt crisis?

There are three options:

1. Assure the markets that the weak sister will indeed be bailed out, notwithstanding the treaty prohibition against doing so.
2. Artificially maintain the country's access to private capital markets by giving investors a "put" of those debt instruments -- "in unlimited quantities" -- to the union's central bank.
3. Repeatedly and relentlessly declare, as a matter both of policy and of sacred honor, that no default on, or restructuring of, sovereign debt within the union will ever be tolerated.

At the commencement of the Eurozone debt crisis in May of 2010, European officialdom could not embrace option 1 for political and other reasons.

Even broaching option 2 at that stage would have been hazardous, again for political reasons.

Which left only option 3.

The risks of attempting to talk the Eurozone out of a contagious debt crisis (as opposed to restructuring the unsustainable debt loads of the affected countries at the outset) were of course visible when the problem began in 2010. The majority of official sector players apparently persuaded themselves that this was the least bad alternative at the time. The reprieve purchased by implicitly promising bondholders an official sector guarantee of their lending to Eurozone sovereigns, however, now puts those official sector actors in a remarkably uncomfortable position. Any suggestion that the implicit guarantee is being withdrawn or even limited

could trigger another bout of the financial contagion that the guarantee was originally intended to suppress. The financial firewalls established in Europe since the onset of the crisis are manifestly insufficient to contain an outbreak of that kind. In short, the official sector may have grasped the wolf by the ears and the tiger by the tail. They cannot safely back away from the implicit promise they have given to private sector creditors but they also lack both the financial resources and the political backing to honor the promise if called upon to do so in a contagious crisis.

Limited Choices

When a sovereign debt instrument falls due, the borrower has two, but only two, choices -- pay it or don't pay it. If the borrower does not itself have the financial resources to pay and cannot access commercial markets to borrow the funds needed to refinance the maturing debt, paying requires the borrower to seek financial assistance from an official sector source, multilateral or bilateral.

The "don't pay" alternative is equally simple. The sovereign either negotiates a restructuring of the debt *before* the claim falls due (and thus avoids an actual payment default) or it fails to pay on the maturity date and attempts to negotiate a restructuring afterwards. Either way, however, "don't pay" means "restructure".

In the case of Greece in the spring of 2010 (and later in Ireland, Portugal and Cyprus), European officialdom could not promise the markets that the afflicted countries would pay their maturing bonds; this would have been tantamount to a pledge to use taxpayer money to bail the countries out. Although such a promise would undoubtedly have resulted in continued market access for the afflicted countries, uttering it aloud was unthinkable for two reasons. First, it would have instantly been attacked as inconsistent with the no-bailout provision of the treaty establishing the monetary union. Second, official sector assistance for the debtor countries was conditioned upon fiscal reform. Promising the markets a bailout -- in effect, *committing* to bail them out -- would have obviously weakened the official sector's hand in negotiating those fiscal reform programs.

Calming the markets through an official sector assurance that the debtor countries *would* pay was thus not feasible. But if the dichotomy boils down to only two choices -- pay or restructure -- the official sector could obliquely promise the markets that maturing debts would be paid

by vehemently ruling out the option that the debts would ever be restructured. Stated differently, if the only options are x or y, you don't need to say "x", you only need to promise "not y".

Abolishing the Death Penalty

This is precisely what some senior European officials attempted to do in the early years of the Eurozone debt crisis. A sovereign debt restructuring in the Eurozone, they broadcast, was impossible, unthinkable, illegal, immoral and fattening.¹ Here are some examples:

"A debt restructuring . . . would be like the death penalty -- which we have abolished in the European Union."²

"Restructuring . . . would entail a major economic, social and even humanitarian disaster within Europe."³

"How can people invest in the euro area . . . if they are told 'we are not sure if you will get your money back'? What kind of advertisement is it for the euro if we tell people 'you can come and invest but we are encouraging restructuring'?"⁴

"In the worst case, the restructuring of a member state could overshadow the effects of the Lehman bankruptcy."⁵

"A debt restructuring in Greece would have major consequences on the soundness of the banking sector in Greece as well as on any banks having exposure to Greek securities."⁶

1 For vivid descriptions of what occurred, see Martin Sandbu, *Europe's Orphan: The Future of the Euro and the Politics of Debt* (2015); Paul Blustein, *Laid Low: The IMF, the Eurozone and the First Rescue of Greece*, CIGI Working Paper 61 (2015); Landon Thomas & Stephen Castle, *The Denials That Trapped Greece*, N.Y. Times, Nov. 5, 2011.

2 Ralph Atkins, *Interview Transcript: Lorenzo Bini Smaghi*, member of the Executive Board of the European Central Bank, FINANCIAL TIMES, May 29, 2011.

3 *Id.*

4 *Id.*

5 *Euro Restructuring Could Overshadow Lehman -- ECB's Stark*, REUTERS, April 23, 2011 (quoting ECB Executive Board member Jurgen Stark); see also Blustein, *supra* note 1 (reporting on ECB President Jean-Claude Trichet's fears of a Lehman-like moment in Europe should Greece embark on plans to restructure its debt in 2010).

6 Jonathan Stearns, *EU's Rehn Warns of 'Devastating' Impact of Greek Restructuring*, BLOOMBERG, May 11, 2011 (quoting Olli Rehn, EU Economic and Monetary Affairs Commissioner).

Contagion

These and similar declarations of the impossibility of a sovereign default or debt restructuring in the Eurozone had one overriding objective -- avoid contagion.

“Contagion” is an interesting word. Most people immediately associate it with a communicable disease. The common cold is contagious. But so, they say, is yawning. Even a catchy tune can be said to be contagious if you find yourself humming it for the rest of the day.

“Financial contagion”, in the context of a sovereign debt crisis, can describe one of two possible phenomena:

Blind contagion occurs when markets, observing fiscal malfeasance or simple misfortune in one debtor country, irrationally recoil from lending to other sovereigns that are wholly innocent of, or unaffected by, the causes of the problem in the trigger country. Blind contagion thus resembles the transmission of a communicable disease. The victim has the bad luck to be in the wrong place at the wrong time when a virus or bacterium is abroad. The sovereign victim of blind financial panic similarly suffers from bad luck; the occasional tendency of markets to become skittish and indiscriminating.

Perceptive contagion, however, results from the market's sudden realization that the causes of the financial distress in the trigger country are also present elsewhere in the region or in the asset class generally. This produces a “golly, if it could happen there, it can happen here” revelation. Countries affected by this form of contagion are not innocent victims of bad luck or bad geography. They are themselves in some way financially vulnerable and thus become predictable casualties whenever investors are forcibly reminded of the risks of sovereign fragility.

If blind contagion is best compared to catching a cold on a crowded subway, perceptive contagion resembles a midsummer cocktail party when a torrential rain storm erupts. Someone at the party, remembering that he left his car window open, bolts outside to effect a remedy. His action reminds the other guests that the front seats of their own automobiles may similarly be at risk. The result? A suddenly empty cocktail party.

Politicians usually try to convince us that sovereign financial contagion is of the *blind* variety while in practice it is normally of the *perceptive kind*.

Financial Contagion in Europe

The main propellant for the official sector's response to the Eurozone debt crisis was thus a fear of contagion -- more precisely, *perceptive* contagion -- on the part of the markets. Greece, which had been borrowing not too many months before at a spread of only 20bp over German Bunds, openly acknowledged its inability to pay its maturing debts out of its own resources. That was a revelatory moment for investors. Might the problems that were laying low the Hellenic Republic -- a huge debt stock, anemic growth, chronic public sector deficits, the inability to devalue the currency -- similarly affect other Eurozone sovereigns? Gosh, the markets might ask themselves, if it happened in Greece, could it also happen in Ireland, Portugal, Spain, Italy, Belgium or France?

The official sector therefore felt itself confronting a clear and present danger of financial contagion across other Eurozone sovereigns. Not a blind contagion, however, in which the markets react irrationally. A spasm of irrationality might have been expected to pass quickly. In 2010, the official sector feared an acutely *perceptive* contagion once investors had been reminded of the limited options facing overindebted countries that belong to a monetary union. The only effective antidote to the spread of that *perceptive* contagion, thought some in the official sector, was an assurance that Eurozone countries would never be permitted to default on or restructure their maturing debts. The implication -- which the market was left to draw for itself -- was that these countries would be the inevitable beneficiaries of a bailout if they lost market access.

When a restructuring of Greek debt did occur in early 2012, of course, Europe did not collapse. The death penalty was not reinstated. Investors did not shun other European sovereigns. There was no Lehman moment. Affected holders of Greek Government Bonds grimaced and grumbled but then moved on, as some observers had always maintained they would. As for the belief that markets, once bruised, never forgive and never forget, Greece itself punctured that theory by issuing new bonds, at a coupon of under 5%, less than two years after inflicting a savage debt restructuring on its old bondholders.

To be sure, the "no default; no restructuring" policy avoided unpleasant negotiations with the private sector creditors of Greece (until 2012), Portugal, Ireland and Cyprus. But the price of this policy was to force a substantial migration of the debts onto the shoulders of official sector creditors. What awaits now is an even more unpleasant discussion

of whether, when and how those official sector lenders will themselves provide the concessions that they generously deflected from private sector investors.

The Implications

Establishing firewalls or shock absorbers like the European Stability Mechanism (authorized share capital € 700 billion) are undoubtedly helpful to quell outbreaks of blind, irrational contagion. An afflicted country can be expected to return to normal funding operations once the panic subsides. Unless vastly expanded in size, however, such firewalls are of less utility when the problem is a fear of perceptive contagion.

By its very nature, perceptive contagion results from a sudden recognition by investors that they -- as sensible, risk averse commercial actors -- ought *not* to be lending to a group of sovereign borrowers, at least not at the coupon levels those countries have come to expect. To be effective, therefore, a financial firewall against perceptive contagion needs to have both the financial resources and the political backing necessary to fund the maturing debts of multiple countries for prolonged periods. The ESM, even augmented by IMF resources, lacks the money and the political support to attempt that gargantuan task.

The latent policy question is whether the official sector wants to consecrate a system by which the market access of a number of European countries is premised not on a sober investor assessment of the creditworthiness of the individual sovereign borrowers, but rather on the market's assumption about an inevitable official sector bailout should a bout of perceptive contagion again break out. If it does, then the objective of European fiscal integration long promoted by some commentators will have largely been achieved, indirectly of course. It strikes us as unlikely, however, that this proposition would enjoy the necessary political support were it to be put directly to the national parliaments.