The Eurozone Debt Crisis
In Historical Perspective

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The First World War was once dubbed "the war to end all wars." No one, to my knowledge, made a similar misjudgment about the global debt crisis that engulfed many emerging market countries in the early 1980s and lasted for the next dozen years or so. There had always been sovereign debt crises; no sensible person believed that the crisis of the 1980s would be the last of its kind.

And it wasn't. Sovereign debt crises have erupted at irregular intervals over the intervening years. Mexico, Russia, Thailand, South Korea, Indonesia, Ecuador, Pakistan, Ukraine, Iraq, Uruguay, Jamaica and many other countries have endured debt problems since the last Brady bond issuance signaled the end of the global debt crisis of the 1980s and early 90s.

Sovereign debt again dominates newspaper headlines. The difference this time, however, is that the afflicted countries fall into the "developed" country category. In the minds of some, this distinction renders the current crisis an utterly unique phenomenon; one that cannot benefit from the lessons of previous sovereign debt crises and one that certainly should not seek in those precedents for clues as to how a sovereign debt crisis ought to be handled.

I do not share this view. Much about the Eurozone debt crisis resembles its emerging market predecessors. Much about the resolution of this crisis ought to be informed by the techniques developed in those prior operations. I therefore propose to undertake a very abbreviated exercise in comparing and contrasting the Eurozone debt crisis with the sovereign debt workout experiences of the 1980s and 90s.

The Cause

The propellant for both the debt crisis of the 1980s and the Eurozone debt crisis is basically the same -- excessively easy credit. In the 1980s, commercial banks -- awash in petrodollar deposits after the oil shocks of the late 1970s -- quite literally fell over themselves to lend to countries like Mexico that appeared for a time to be the beneficiaries of those oil shocks. In Europe, the market's failure to distinguish between the creditworthiness of countries like Greece and Germany allowed the former to borrow at just a few basis points above the latter. It was an illusion that no one in the official sector seemed eager to shatter at the time.

Fiscal discipline was in the beginning, is now and ever shall be, world without end (amen), politically unpopular. Give politicians an easy way to evade that unpopularity by borrowing cheaply to cover chronic budget deficits and they will take it. Mostly every time. Mostly every country.

The Trigger

The immediate trigger for the two crises, however, was different. The debt stocks accumulated by sovereigns in the late 1970s and early 1980s carried floating interest rates (mainly LIBOR). The debt crisis of the 1980s thus became unavoidable once Paul Volcker (then Chairman of the Federal Reserve) decided to "wring" double-digit inflation out of the American economy by sharply increasing U.S. dollar interest rates. LIBOR topped out at 22% in 1981.

Interest rates hikes were <u>not</u> the undoing of peripheral Europe. Although there were several contributing factors, I believe that the proximate trigger this time was a general market wariness of borrowers, both corporate and sovereign, whose very survival depends on perpetually benignant markets. This was a legacy of the financial crisis of 2007-08. Lehman Brothers did not last 24 hours -- indeed not 12 hours -- after it lost the confidence of its lenders and repo counterparties.

It is hard to predict just when this sort of skittishness will infect the market. There are many examples of situations in which investors are prepared to continue lending to borrowers whose near hopeless addiction to easy money is perfectly visible. The most accurate explanation may be olfactory -- markets can smell desperation in a borrower. And it is that pungent scent of desperation that will cause lenders, as a group, to become restive. Think of a buffalo herd twitching as it catches the first hint of smoke on the wind.

In early 2010, the market decided that even developed country sovereign borrowers -- at least those that don't print the currency in which they borrow -- can show a similar vulnerability. If denied access to private markets at tolerable interest rates for more than a few months, some sovereigns will find their backs against the proverbial wall. Default or bailout are the only options. This dawn crept over the horizon of lenders to Eurozone sovereigns only last spring when Greece's back came flush to that wall.

<u>The Creditors</u>

In 1982, the private sector lenders to emerging market sovereign borrowers were almost exclusively commercial banks. When the crisis hit, the solvency of many of the world's large international banks was called into question. The debt restructuring technique employed during the "Baker Plan" period between 1982 and 1989 was therefore expressly designed to avoid the need for commercial banks to take any writedowns of the value of their sovereign portfolios. To be sure, when a secondary market in this paper began to develop in 1985, it required some strong-arming of bank auditors and regulators to convince them to approve a valuation of loans to a debtor country at 100¢ (or close to it) when identical loans were trading in the secondary market at 8¢ or 20¢ on the dollar.

Not much has changed.

The principal lenders to the European Eurozone sovereigns are European commercial banks, some of which are dangerously overexposed to peripheral countries. The current full-bailout response of the EU and the ECB to the crisis is driven in large part by a similar concern over the solvency of the creditor banks. Why, the argument goes, would official sector lenders balk at giving money to a country to pay its maturing debts when to deny that assistance would only force those same lenders to spend an equivalent amount of money to recapitalize their domestic banking systems?

The Debt Instruments

The debt instruments that were sucked into the maw of the global debt crisis in the 1980s were syndicated commercial bank loans. The debt instruments caught up in the Eurozone debt crisis are for the most part freely tradable bonds.

It is now clear, however, that the form of the debt instrument is far less significant in this context than its accounting treatment. A bank was not required in the 1980s to write down the value of its sovereign loan assets unless the bank's management had concluded that the collectibility of those loans had in fact diminished. The Baker Plan debt restructuring technique prevailing between 1982 and 1987 was intended to avoid forcing bank managers to reach this conclusion. Under the Baker Plan, the principal component of the debt was rescheduled and the interest was paid currently. Of course, the only way that interest *could* be paid currently was for the bank recipients to lend equivalent amounts to the sovereign debtors through infamous "new money" loans. But even this blatant propping up of one's own debtor did not induce the bank regulators or auditors to force a balance sheet writedown of the loans.

The same accounting effect is achieved in 2011 by allowing commercial banks to hold the bonds of peripheral Eurozone countries in their "hold to maturity" accounts. Even if identical bonds are trading in the market at 50¢ on the Euro, bank managers are allowed to take comfort from the repeated assurances of the ECB and others that no Eurozone sovereign debt instrument in existence today will ever be allowed to default or to endure the indignity of a debt restructuring, as long as banks profess an intention to hold those bonds to maturity.

The Remedies

When the Mexican debt crisis began in August 1982, a delegation of commercial bankers went to Washington, D.C. with a request (addressed to the U.S. Government, the IMF and the World Bank) that the official sector somehow backstop Mexico's debts to the international banking community. This could be done, the banks said, either by the official sector lending Mexico the money it needed to continue normal servicing of its bank loans, or through some form of official sector guarantee of the borrowings.

To use a twenty-first century locution, these bankers were bluntly told in Washington to "man up" to the consequences of their lending decisions. A dozen years of sovereign debt restructuring followed. The only concession to the banks was strong official sector support for a debt restructuring technique (the Baker Plan) that avoided accounting hits to their sovereign portfolios. Notwithstanding these public assurances that banks' balance sheets would be protected, however, bank regulators were quietly insisting that overexposed commercial banks provision their loan loss reserves against an eventual writedown.

In the spring of 2010, "man up" was *not* the message given to Greek bondholders. Instead, the official sector (in this case, the EU and the IMF) agreed to do precisely what their counterparts had declined to accept in 1982 -- provide the debtor country with a complete bailout package. As Greece's existing bonds mature, they are paid off, in full and on time, by drawing down on the EU/IMF bailout facility. Month by month, therefore, the character of Greece's debt stock changes. The debt effectively migrates out of the hands of commercial creditors (who can be slapped around by debt restructurers when necessary) and into the paws of official sector lenders, the EU and the IMF (who claim for themselves a "preferred creditor" status).

Nothing remotely like this happened in the 1980s and 1990s. Why should the official sector have been so eager in 2010 to pursue a total bailout policy that it found utterly repugnant thirty years ago?

The reasons most often given are:

- A restructuring of the debt of a Eurozone sovereign risks contagion among the other peripherals;
- European commercial banks are overexposed and a debt restructuring invites a banking crisis in northern Europe;
- Restructuring one Euro of sovereign indebtedness may, it is said, indelibly stain the reputation of the Euro; a poison will have been injected into the vital organs of the Euro-body that will, in the space of a couple of years, kill the noble experiment of European integration; and
- A developed country cannot restructure its debt without sacrificing its status as a developed country.

The Endgames

When the commercial bankers of the 1980s were told by U.S. Treasury Secretary James Baker that they would never have to book a loss on their sovereign loan portfolios, what he really meant was "never while I am in office." Secretary Baker's successor, Nicholas Brady, did not feel bound by this pledge. On March 10, 1989, Secretary Brady gave a speech in Washington, D.C. in which he urged the banking community to write off a portion of their loans to troubled debtor countries in order to break the seemingly endless cycle of serial debt restructurings and new money extortions. The eventual conversion of commercial bank loan portfolios into 30-year Brady bonds (with a haircut either to the principal or the interest rate) did just that; it ended the debt crisis for country after debtor country.

How will the endgame play out in Europe? Well, shades of Jim Baker, European policy makers have to date repeatedly assured holders of peripheral sovereign bonds that those instruments are money good; Europe and the IMF will do whatever it takes to ensure that no Eurozone sovereign debt instrument in existence today will ever default or be restructured.

Of course, no one in the market actually believes this. On the current path, Greece will enter 2014 with a debt stock of 160-70 percent of GDP, well over half of it owed to official sector lenders that profess some form of preferred creditor status. Will the market gladly finance a country with this debt profile when the bailout package ends? Unlikely. That is why long-term Greek bonds can be purchased for 50¢ on the Euro.

The two options for Greece are therefore to declare itself a ward of the official sector for many years to come, or to restructure its unsustainable debt load. The first option is likely to be politically unacceptable, in Greece if not in Germany. That leaves the second -- restructuring. The real question is when?

If a Greek debt restructuring is launched before mid-2013, I believe it will be advertised as a wholly voluntary affair. The Europeans will do this to avoid the infamy that they seem to attach to the word "restructuring", to keep faith with their promises that there never will be a restructuring of existing Eurozone sovereign debt, and to protect the balance sheets of the creditor banks. I believe that the official sector will therefore seek a more euphonious description such as "voluntary liability management transaction".

The problem, however, is that truly voluntary sovereign liability management transactions are expensive and rarely deal decisively with the country's debt stock. The creditors start with the proposition that they will not be asked to suffer a loss (in a net present value sense) by participating in the transaction. This means that the negative NPV consequences of even a mild "reprofiling" of near-term maturities -- stretching them out for five or seven years, for example -- would have to be paid for by offering the creditors some form of credit enhancement on the new instrument.

In such a transaction, the debt stock can be pushed down the road, but it cannot be significantly reduced. It is like a child who has lost his appetite at dinner. The food will be pushed around and rearranged, but the absolute quantum of food on the plate at the end of the meal will be roughly the same as at the beginning.

A voluntary restructuring of the Greek debt launched before 2013 would probably take the form of a par debt exchange. The first question will be whether to provide credit enhancement (in the form of collateral or a guarantee from an official sector source) on the exchange instrument. The alternative would be to lean on the accountants to permit commercial banks to carry over to the new exchange instrument the same valuation shown on their existing paper. The commercial bank holders of Greek bonds would naturally prefer the former, but douceurs of this kind are expensive for the debtor country. An unenhanced exchange instrument would therefore be preferable to Greece and its official sector sponsors, as long as the valuation question can be resolved satisfactorily. A related question will be whether enough holders of Greece's existing bonds can be persuaded to participate in a purely voluntary exchange to make much of a difference to the debt dynamics.

A restructuring of Greek debt launched after 2013 would be a much different affair. For one thing, by that point more than half of the debt will be in the hands of the EU, the IMF and the ECB. Preferred creditors or not, those institutions will have no choice but to restructure their own claims against the country. The implications of this for an institution like the IMF (which has traditionally taken a "we never restructure" position) could be significant and long-lasting.

One final comment -- the options facing a country like Greece are not total bailout on the one hand, or the sad and messy spectacle of a payment default followed by creditor lawsuits, attachments, and denied market access for many years on the other.

No one is talking about that kind of a restructuring.

Several countries have done pre-emptive debt restructurings before any payments on existing instruments were missed. Uruguay in 2003 is a good example. Belize in 2007 is another. In short, “restructuring” does not automatically mean “default”.

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