DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

DEBT RESTRUCTURING

BRIEFING NOTE

Abstract

The perils of debt restructuring are easily overestimated, as are the chances of avoiding such a step. Facing an unending recession – meaning that GDP continuously declines – a number of euro area countries probably have passed the point of no return. Conversely, the hopes of voluntary and orderly restructuring are bound to be disappointed. The experience with debt restructuring, a not-so-rare event, shows that there are costs but also benefits, mainly in the form a quick resumption of growth.

In the absence of collective action clauses, the negotiation process is bound to be long and painful, not voluntary and orderly. The largest risk is not the usual difficulty of gathering creditors into a coherent group, but politicization. With their banks under threat and facing direct losses as official creditors and shareholders of the ECB, governments may interfere and gravely complicate the negotiation process.

The ECB had good arguments to argue against debt restructuring but this is likely to be eventually a losing battle. The ECB should instead prepare itself to intervene to avoid banking system instability in the difficult situation when some governments will be in default.

IP/A/ECON/NT/2011-02 June 2011

(Part of the compilation PE XXX.XXX for the Monetary Dialogue) EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR

Charles WYPLOSZ
Graduate Institute of International and Development Studies, Geneva

RESPONSIBLE ADMINISTRATOR

Rudolf MAIER
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@europarl.europa.eu

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its newsletter please write to:
Poldep-Economy-Science@europarl.europa.eu

Manuscript completed in June 2011
Brussels, © European Parliament, 2011.

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EXECUTIVE SUMMARY

Sovereign defaults are not exceptional and disastrous events. They happen relatively frequently, usually after a recession. Typically, they are followed by a rapid resumption of growth. But they carry costs that should not be underestimated either. Access to market borrowing is closed during the negotiation period and the interest rate on borrowing remains high for quite some time, especially if the haircut – the reduction in debt value – is large.

The negotiations that follow a cessation of payments are usually long and difficult, especially in the absence of collective action clauses – and sometimes even with them. Debt restructuring cannot be voluntary, those who stand to lose usually fight back and vulture funds – investors who buy the bonds at distressed price and block agreements until they make a profit. For that reason, "orderly debt restructuring" is most unlikely.

The situation in the euro area is not encouraging. Existing debts do not include collective action clauses, the debtors are often foreign banks whose governments are likely to get involved, thus injecting political gaming in an already complicated process. Worse, the other governments stand to suffer losses, either as they need to recapitalize their own banks or through ECB losses, further politicizing the process.

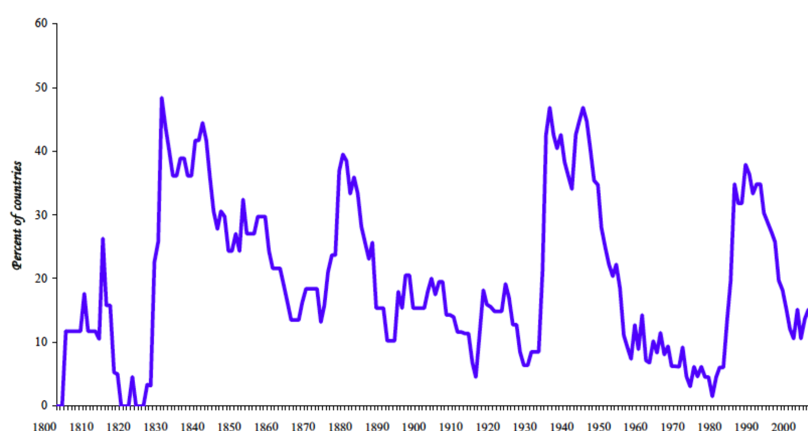
While these aspects explain the widespread opposition of officials to any restructuring, reality cannot brushed aside much longer. Once the financial markets have lost faith in a country's ability to honour its debt commitments, debt restructuring is almost always unavoidable. The ECB's warnings against contagion and bank instability are correct but they do not justify delaying the inevitable. The countries under market pressure are going through deep recessions, which are unlikely to come to an end as long as excessively ambitious deficit-reducing measures undermine their very objective.

In the plausible event of a default followed by a banking crisis, the EBC will find itself in an unforeseen situation. It will have to intervene as lender-of-last-resort but it may be unable to secure the corresponding guarantees from government authorities that are in a default situation. This is not a good enough reason for the ECB not to intervene, but it requires careful preparation and precise communication when executing the procedure.

1. DEBT RESTRUCTURING: NOT SO RARE

The possibility that a European country might default on its sovereign debt is often seen as unthinkable because this is an exceptional event and because "we don't do this sort of thing". This is not what the data say. Figure 1 shows that, with the exception of the 1960s and 1970s, years marked by a high degree of financial repression, it is often some 20% to 30% of governments that are in default – meaning that they are not fulfilling their debt obligations as agreed upon at the time of borrowing. Defaults do occur, fairly frequently.

Figure 1. Percent of countries in default



Source: Reinhart and Rogoff (2009)

A substantial literature also documents when defaults occur. The survey by Borenzstein and Panizza (2008) recounts a once-again familiar story. Sovereign debt defaults tend to occur more often when growth is weak (or negative) and volatile, after a period of rapid credit growth, when institutions are weak and when there is a history of defaults. Importantly, defaults tend to cluster, a clear indication that contagion has to be a preoccupation.

It is not true that there have not been many defaults recently. Yet, it is not true that it never happens. Table 1 shows that a number of countries have defaulted on their public debts over the last century. It is noteworthy that these events have almost always occurred in extreme conditions, mostly political. This does not apply to the current situation, yet the economic and financial crisis that started in 2007 is an episode of historical proportion. In addition, over the last two or three decades, many countries have displayed a surprising degree of fiscal indiscipline.

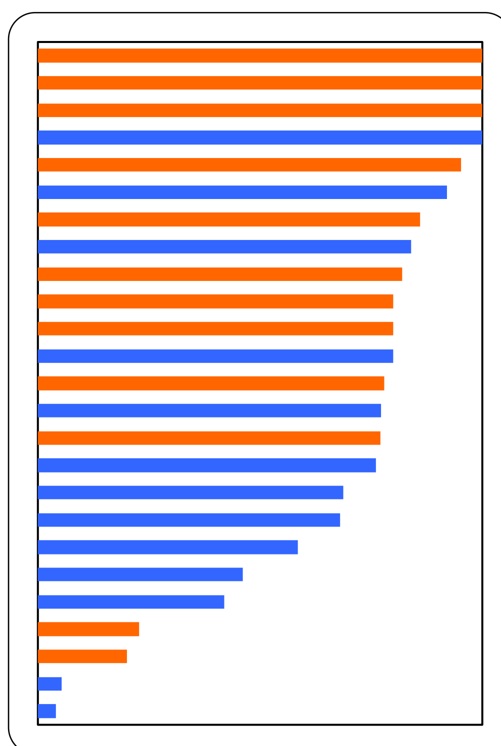
Table 1. European sovereign defaults since World War I

Austria	1932		Hungary	1932
Austria	1938		Hungary	1941
Austria	1940		Italy	1940
Bulgaria	1932		Poland	1936
Czechoslovakia	1938		Poland	1940
Czechoslovakia	1959		Romania	1933
Germany	1932		Yugoslavia	1933
Germany	1939		Yugoslavia	1992
Greece	1932			

Source: Borenzstein and Panizza (2008)

Figure 2 looks at the fiscal discipline performance of the developed and emerging-market countries in the OECD database. It displays the percentage of years when the budget was in deficit over the period 1960-2011, although the period included in the database is much shorter for a number of countries. The message, however, is clear: most of countries have rarely run a balanced budget and some have never done so over the period for which the data is available. This has never been the case previously in peacetime, when sustained deficits used to occur only during war or politically troubled years, precisely the situation that is associated with defaults. Viewed this way, the possibility that defaults may happen should be seen as unusual by historical standards.

Figure 2. Percent of years with budget deficit (1960-2011)



Source: Economic Outlook, OECD
Note: The sample period is 1960-2011 but the time series do not cover the whole period for several countries. This is in particular the case of the former communist countries for which the sample period starts in 1995. Euro area countries are shown in orange.

2. EXPERIENCE WITH DEBT RESTRUCTURING

The general perception is that debt-restructuring episodes are cataclysmic events, for both the defaulting country and the creditors. Thus, it is usually believed that defaults are followed by years of miserable growth. A review of a large number of episodes shows that, typically, growth is negative before a default episode – indeed the proximate cause of the default – and quickly recovers afterwards, see Table 2.

Similarly, it is often assumed that it takes years for countries to recover access to financial markets and that subsequent borrowings entail a large penalty in the form of higher costs. The evidence is more subtle. A recent study by Cruces and Trebesch (2010), which looks at all defaults during the period 1970-2077, indicates that the punishment depends on the size of the restructuring (the haircut).

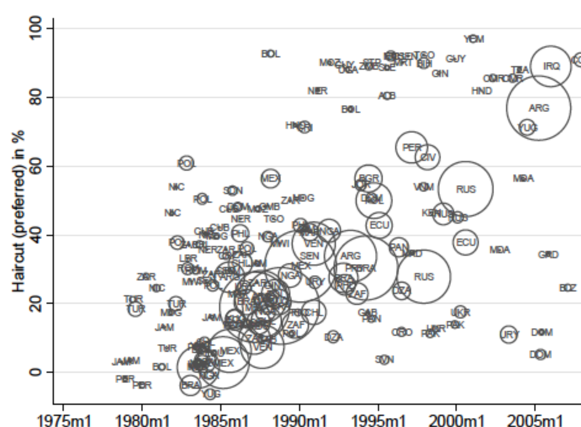
Table 2. Growth before and after a default

Period	Average GDP growth
Three years before default	-1.9
Three years after default	2.9

Source: Reinhart and Rogoff (2009), p.111.

The haircut varies greatly from one country to another. Cruces and Trebesch (2010) finds that the average haircut is 36%. This average, however, conceals considerable variability both across countries and over time, with a tendency toward larger haircuts, as Figure 3 shows.

Figure 3. Haircuts in debt restructurings – 1970-2007



Note: The Figure plots the size of haircuts in % (H_{SZ} from eq. 2) across countries and time. The circle size reflects the volume of debt restructured (in current USD)

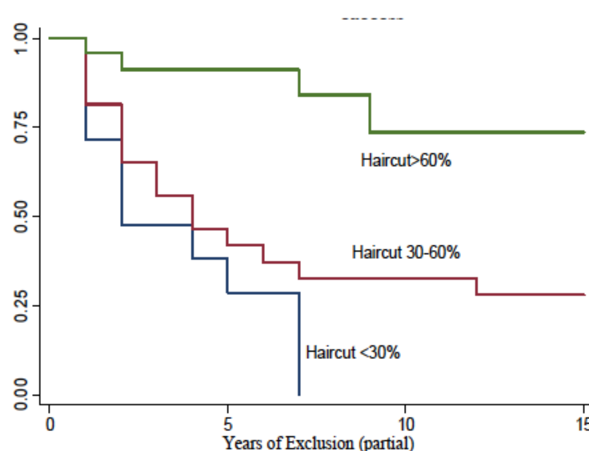
Source: Cruces and Trebesch (2010)

Regarding the duration of the punishment, a defaulting government becomes a pariah on financial markets, but this lasts only until an agreement is reached with the creditors. As soon as this is achieved, the experience is that lending promptly resumes. The duration of market exclusion therefore depends on the length of the negotiations. Here the evidence

draws the attention to who the creditors are (Borensztein and Panizza, 2008). When the creditors are banks (domestic and/or foreign), it is often easy to organize a single committee that can relatively quickly reach an agreement with the defaulting government. When instead the debt is in the form of widely distributed bonds, negotiations are much more complicated and protracted. Governments typically make offers but holdovers – and specialized "vulture funds" – keep refusing these offers as they attempt to get better deals than the other creditors. Subsequent litigation can take years.

Cruces and Trebesch (2010) also shows that the duration of the punishment is related to the size of the haircut. Figure 4 shows that for moderate haircuts (less than 30%), half of the defaulting governments can borrow again within three years of restructuring while most large defaulters cannot borrow again a decade later.

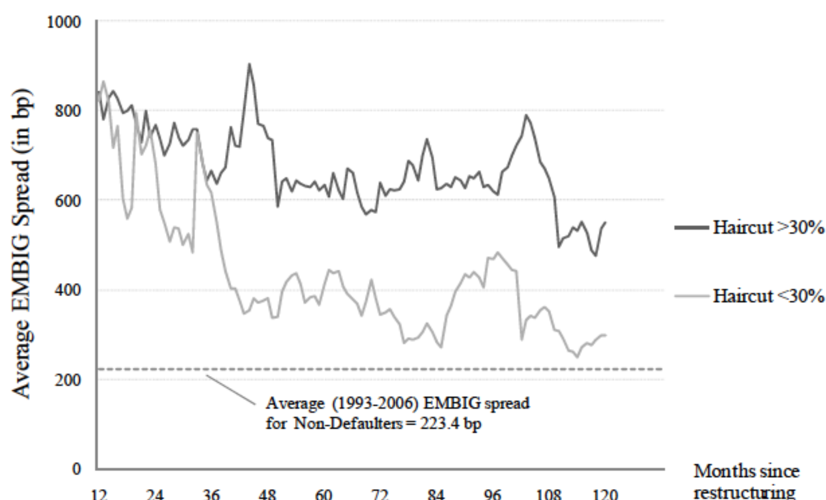
Figure 4. Duration of exclusion from market access



Source: Cruces and Trebesch (2010)
Note: the vertical axis indicates the proportion of countries that have not recovered market access, the horizontal access shows the number years after restructuring.

Regarding the cost of post-restructuring borrowing, Cruces and Trebesch (2010) find that it is very directly linked to the haircut. This is shown in Figure 5, which plots the average spread of interest rates charged on dollar-denominated bonds over US Treasury bonds of the same maturity. (The EMBIG spread is computed for a sample of emerging market countries). Governments with low haircuts (less than 30%) face little penalty within 4 years of restructuring while haircuts of more than 50% seem to entail a permanent penalty.

Figure 5. Spreads following restructuring



Source: Cruces and Trebesch (2010)

3. RESTRUCTURING IN THE EURO AREA

This section deals with three questions: 1) how does one think about the desirability of debt restructuring in the euro area? 2) how can that be done? 3) what are the potential costs?

Can debt restructuring be desirable?

A blanket rejection of any default is simply not credible. Once markets are convinced that there is possibility, even remote, of a default, even partial, interest rates rise with no upper limit, until market access is lost altogether. At that stage, the government must rely entirely of official lending to rollover its maturing debt and to finance possible deficits. One solution is to generate a budget surplus sufficient to rollover maturing debt, but this is not a realistic option for the euro area countries under market pressure. This means that the government depends entirely on official lending, which is conditional and not unlimited. A default is a distinct possibility because it may be more desirable than continuing official lending: one must compare the costs of each option.

The IMF and the EFSF lend at a cost that includes a profit margin. These are not presents, therefore, but not-so-cheap loans. In addition, they impose conditions that amount to a strongly contractionary fiscal policy stance. The European Commission has argued for a rapid reduction in budget deficits, partly to meet the requirements of the Stability and Growth Pact, partly because the political acceptability of the loans is limited in a number of countries. The borrowing countries are in recession and the conditions attached to the loans are bound to delay any recovery. This is indeed what the Commission foresees, see Table 3. The economic and social costs associated with this forecast are very sizeable. The evidence presented in Table 2 suggests that a debt restructuring may significantly change the outlook. In fact, the financial markets believe that the respective governments will eventually ain for rapid growth, not just to reduce the economic and social costs of a protracted recession, not just because they may be forced to by their public opinions, but also because lasting deficit reductions are achieved almost always when the economy is growing.

Table 3. Unemployment rates

	2006	2007	2008	2009	2010	2011	2012
Ireland	4.5	4.6	6.3	11.9	13.7	14.6	14
Greece	8.9	8.3	7.7	9.5	12.6	15.2	15.3
Spain	8.5	8.3	11.3	18	20.1	20.6	20.2
Portugal	7.8	8.1	7.7	9.6	11	12.3	13

Source: AMECO, European Commission

Features of possible debt restructuring

Current quasi-official discussions centre on the notion of "orderly and voluntary restructuring". This is entirely illusory. Debt restructurings change the initial loan contracts in a way that always entail losses to the lenders. For this reason, they are never voluntary and therefore trigger negotiations that are bound to be disorderly. Current sovereign borrowings do not include collective action clauses that greatly simplify negotiations with the myriad of bondholders that need to be organized.

An aggravating factor is that any debt restructuring is likely to harm many banks in the euro area. Undoubtedly, the corresponding national authorities will want to get involved to protect their banks, if only because bank bailouts have happened recently there. Thus, the normally messy negotiations between the defaulting government and its private creditors will be greatly complicated. A further aggravating factor is that all euro area countries are now official creditors via EFSF loans and via the ECB. Thus, even if they were ready not to interfere to protect their banks, they would still have to be involved as creditors. As such, they may find themselves pitted against their own banks.

It is therefore highly desirable that potential debt restructuring be prepared as a matter of urgency. An agreement is needed to limit official interference in negotiations between the defaulting government and its private creditors. The agreement must also specify *ex ante* how official loans will be treated. They can be made senior, increasing the costs borne by the private creditors but protecting the taxpayers, although taxpayers could be involved in a second step if some banks need to be bailed out. Alternatively, banks may be protected by an agreement to make official loans junior, thus immediately imposing a cost to taxpayers. These are difficult decisions, but they will be even more difficult to make in the midst of a disorderly process.

Costs of debt restructuring

Going to default only makes sense if the eventual haircut is sizeable. At the same time, the evidence is that large haircuts carry long-lasting penalties. In addition, large haircuts will hurt domestic and other European banks, potentially triggering a contagious effect. These considerations suggest that, in the event of debt restructuring(s), haircuts will tend to be moderate. This would lead to limited costs.

4. RESTRUCTURING AND THE ECB

Very early on the ECB has warned against the default temptation. It has argued that a default would be contagious and that banking systems throughout the euro area would be in jeopardy. These are powerful arguments. On the other hand, the ECB'S insistence that the Stability and Growth Pact should be promptly honoured and that deficits must be closed as a matter of a priority ignores the self-defeating feature of such policies when GDP levels are continuously declining, not to mention the associated economic and social costs. Finally, the ECB's refusal to recognize the mounting market pressure leaves it vulnerable to appear as not just inflexible but also as lacking realism.

If a default occurs, the ECB will be in a very difficult position. Having acquired significant of distressed bonds, either as outright purchases through its bond-buying programme, or as collateral for open-market operations. Even though the ECB has applied haircuts, it stands to suffer losses in case of defaults. Formally, the ECB can operate normally with a low level of capital, or even no capital at all, so the costs would be symbolic. They would appear as a negative judgment on the ECB's involvement in the sovereign debt crisis and its willingness to bailout governments in difficulty.

In the event that some banks – possible whole banking systems – need to be bailed out, the ECB will not be able to stand aside; the ESCB is the lender in last resort. The costs of such an operation are to be borne by the host country, which in this case would already be in default. This would further increase the exposure of the ECB, hence recent statements that it would insist on valuable collateral. How his can be arranged in the midst of a banking crisis that unfolds in a defaulting country needs to be worked out. It is likely to involve bank nationalisations and the creation of repository "good banks". This requires careful advance preparation and, when the time comes, clear and transparent communication.

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