Istituto Affari Internazionali

Sovereign Debt Crises: Prevention and Management
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Background note[1]

At the end of 2017 the Commission presented a comprehensive set of reform proposals of the European governance. An important element of the package is the transformation of the European Stability Mechanism (ESM) into a fully fledged European Monetary Fund (EMF) which would play a more extensive and incisive role in crisis management and assistance to member countries in difficulty. This has set in motion a lively discussion, with contributions of European leaders, economists and various commentators. There is wide agreement on the broad objectives, namely to enhance market discipline, limit moral hazard and facilitate policy adjustment for countries in distress. However, views diverge widely on which of these objectives to emphasize most and the instruments and procedures to achieve them.

According to some, the key instrument would be to force a country with unsustainable debt to restructure its debt in accordance with criteria that would leave little room for discretion. A strictly rule-based **S**overeign Debt Restructuring Mechanism (SDRM) would be the instrument to foster fiscal adjustment through market discipline while at the same time limiting moral hazard.

According to others, it is true that markets do not normally ensure an adequate fiscal discipline in normal times, but they can also over-react in difficult times. A poorly managed liquidity crisis can lead to an unjustified solvency crisis with a severe impact on the economic and policy conditions of the countries affected and Europe as a whole. Furthermore, the expectation of a debt restructuring could amplify the risks of a run on debt and raise the expectation of a possible reversibility of the euro. The decision making process of the EMF should therefore leave some room for discretion and follow a case by case approach.

There are of course also various other positions which view Debt Restructuring as a very last resort, to be applied only on the basis of an in depth, rule based, Debt Sustainability Analysis (DSA) of the country. Another important issue is the transparency of the DSA and the access of the public to that information.

This issue is inevitably very controversial and not only for political reasons. While in the domestic environment there is in principle a clear distinction between the policy instruments for dealing with banks' liquidity risk and those for dealing with solvency risk, it is very dif-

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ficult to replicate these arrangements at the international level and for sovereign debtors. First, dealing with a crisis entails temporary shifts of resources from creditors to debtors, and creditor countries are understandably reluctant to provide resources to profligate sovereigns. Second, an international lender cannot have the same formal supervisory and enforcement powers that a domestic lender of last resort has with respect to a bank. Third, the financial situation of a country depends on the policy actions the country is willing to take and each country is exposed to specific risks and vulnerabilities. Finally, and perhaps most importantly, while domestically fiscal resources can ultimately be mobilized to deal with a systemic crisis, after applying bail in procedures, at the European level common fiscal resources are not available. The result is that most of the adjustment falls on the debtor country and that the adjustment is usually excessively delayed.

Another important aspect to consider is that treating a sovereign 'debtor' as an agent endowed with perfect rationality and a long term perspective is not very useful when dealing with the relationship between sovereign states or between sovereign states and supranational institutions.

Issues for discussion

1. Assessing debt sustainability

Currently, when a euro area member state makes a request for financial support to the ESM (possibly in conjunction with a similar request to the IMF), the ESM must first ask the European Commission and the ECB to assess whether the country's public debt is sustainable. According to the SDRM proponents, because of political pressures, the ESM, the EC and the ECB, and even the IMF - as proven by the Greek case - are prone to consider a sovereign debt to be sustainable even when it is not. The consequence is an increase in the cost of the crises. Governments of debtor countries have an incentive to delay admitting that their debt is unsustainable and investors in creditor countries have weaker incentives to monitor the creditworthiness of the sovereign. However, the concept of debt sustainability is a very elusive one, because countries can afford high debt for prolonged periods of time and if they lose access to markets it does not necessarily mean that they are bankrupt. What really matters is the political and economic feasibility of a fiscal policy capable to stabilize the debt.

Can the DSA be based exclusively on technical considerations? How realistic should the underlying assumptions about the budget evolution be? To what extent should they take into consideration the stated policy commitment of the country's government? How should country-specific or area-specific factors affecting the capacity of a country to maintain a

certain debt level be considered in the analysis? How should stress scenarios be designed? What is the record of past DSA analyses made by the IMF?

2. Safety nets and liquidity assistance to sovereigns

Markets are prone to over-react in periods of stress, especially in the Euro-area where transaction costs have been minimized, thanks to the abolition of currency risk, the elimination of capital controls and the creation of an integrated payment system. Furthermore, as is well known, euro-area countries borrow in domestic currency but, since no sovereign state has the independent right to issue it, a reversal of capital flows in the absence of an international lender of last resort has an immediate impact on perceptions of default risk or even of a reversal of the euro. These perceptions can set in motion a self-reinforcing vicious circle of drop of asset prices, increase in margin calls and in haircuts on bonds used for collateral, which induce further sales of financial assets. Markets become highly illiquid, risk premia become excessively high, and sovereign borrowers can lose access to markets.

The creation of the ESM in 2012 and the ECB's announcement of the introduction of the OMT facility proved to be key factors in protecting financial stability and limiting contagion during the most acute phase of the European sovereign debt crisis. There seems to be now a consensus on the need to provide liquidity facilities which prequalified countries could use when facing difficult market conditions.

This raises various issues that require more in-depth analysis: (a) What volume of funds should be available for liquidity support? Some claim that only the promise to provide an unlimited amount of funds would be able to restore confidence in the case of a serious crisis but this may be highly unrealistic and in contrast with the need to avoid moral hazard. (b) Even if the conditions for access to the ESM facilities were simplified, their use may still bear a stigma effect because it may send the signal that the country fears the loss of access to financial markets and result in a sign of weakness rather than strength. On the political side, policymakers could see any recourse to the ESM as a risk to their political reputation, especially in periods close to elections.

Could the stigma effect be reduced by offering greater predictability of access and more favorable terms? Should there be a risk-based model of member countries' contributions to these facilities? What has been the experience of the IMF with respect to flexible and precautionary credit lines? What type of policy conditionality should be attached to lending programs in order to create effective incentives to introduce policy reforms?

3. Debt restructuring. The economic and political dimensions.

According to the proponents of the Sovereign Debt Restructuring Mechanism (SDRM), an insolvent country should not receive assistance unless it restructures its debt or extends its maturity. The lack of a formal insolvency framework for sovereigns reduces market discipline and weakens the no-bailout clause. Only an SDRM would foster fiscal adjustment and, if properly designed, could also protect creditors. It is not clear whether the sovereign insolvency procedures would aim at creating some form of protection also for the debtor as in most domestic bankruptcy legislations.

There are of course various proposals regarding debt restructuring, with some based on numerical triggers and thresholds and other more on an analytical assessment which would leave some room for discretion. Another, more technical aspect of this debate regards the Collective Action Clauses to be applied to the bond contracts to make it more difficult for small groups of creditors to block restructuring plans.

These proposals raise a number of concerns, especially with regard to high-debt countries. The first is the risk that, because of the complexity of assessing debt sustainability, the process becomes highly politicized, which in a European context could have serious foreign policy consequences. The second issue is that, in part to avoid politicization, the process could be based on quantitative "objective" thresholds. This however could have the perverse effect of increasing the likelihood of a self-fulfilling debt crisis as soon as the debt gets close to the numerical trigger. The third issue is that in countries where the public debt is held mainly domestically, restructuring could have a major impact on domestic demand with adverse effects on the financial sector, even if the financial sector were not exposed to the sovereign. A "forced" debt restructuring could finally polarize economic conditions in Europe and give further support to the political forces in favor of a break-up of the euro.

To reduce the political and economic risks of a debt restructuring could some form of fiscal risk-sharing be conceived? What are the ex-ante conditions, especially with respect to legacy debt, that should be met before introducing formal sovereign insolvency procedures? Could transitional arrangements be introduced to avoid perverse destabilizing effects? In order to ultimately restore confidence in financial markets what would be the right mix of debt restructuring and liquidity support? What has been the economic and political impact of recent past debt restructuring of medium-sized economies? What measures could be taken at the European level to offset part of the impact of debt restructuring on domestic demand and the stability of the financial sector? Would mild forms of debt restructuring, such as maturity extensions, be practicable?

4. European lender of last resort: governance and institutional arrangements.

A first issue concerns the ESM's lending rules and the possible margins of flexibility or "constructive ambiguity" in following them. The basic tenet is lending for illiquidity and not for insolvency, on the basis of a set of pre-established contingencies and criteria. However official lenders cannot be denied the capacity to address unanticipated tail-risk events with adverse systemic implications. In order to establish an effective international lender of last resort, countries cannot escape facing a difficult dilemma: either surrender some sovereignty and delegate authority to the supranational institution in charge of this function or accept a strict ruled-based system and some form of semi-automatic debt restructuring at times of crisis.

A second issue is whether the role of certifier of sound economic policies and that of provider of funds should be assigned to the same institution. This debate echoes the one whether central banks, as lenders of last resort, should also be in charge of supervision. Those in favor stress the impartiality that this would give to the whole process. Those against remark that the nature of the assessment is not merely technical, especially when dealing with sovereign states and that assigning this task to a technical body could ultimately run the risk of politicizing it.

Another additional issue is the autonomy and effectiveness of decision-making processes. Bodies of large size are not appropriate for rapid decisions and informal discussions. At the same time, it seems very unrealistic to conceive a constituency system as the one adopted by the Bretton Woods Institutions. To increase the independence of the ESM governing bodies, what should be the relationship between the directors and the governments that appoint them? Should decision making be based on majority voting and not subject, as is currently the case, to previous national parliamentary approval? Finally, there is the issue of who should be the overseer of the ESM and the body to which the ESM should be accountable. Should that be the European Parliament?

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