Sovereign Debt Crises: Prevention and Management

Rome, December 10, 2018

Introductory comments by Franco Passacantando

I will briefly explain the structure of this conference and the issues we would like to cover. Let me first clarify one point. The ultimate responsibility of a sovereign crisis typically lies either in poor fiscal discipline or in excessive credit growth, not adequately contrasted by domestic supervisory authorities. However, the focus of our conference will not be on these domestic factors but on the instruments and institutions available to prevent that the crisis in one country evolves into a systemic crisis, eventually affecting Europe as a whole, as it happened in 2011-2012.

Debt sustainability. The key institution that has been created to play a role in this respect is the ESM and there is a wide consensus that its role should be strengthened in two directions: acting as a backstop to the Single Resolution Fund and providing temporary financial support to countries in financial difficulty. With respect to this latter function, the key condition is that the debt of the country is sustainable, because if the debt is unsustainable any financial support would violate the no bail out clause of the EMU. It would also delay an inevitable debt restructuring and eventually make it much more costly. So the first issue we will address is the Debt Sustainability Assessment (DSA) of a country. It is a very complex issue because DSA depends not only on a number of exogenous and difficult to predict factors, but also on the expectation about the country's political willingness to correct its imbalances. For instance, there can be a country like Japan with a very high debt which can afford it because it enjoys very low interest rates. And there can instead be a country with a debt that is lower but which can become unsustainable as a result of rising interest rates. A rapid increase in interest rates can in fact set in motion what is usually called a self-fulfilling debt crisis. It is a complicated mechanism but for illustrative purposes it can be explained in simple terms. Interest rates rise because of fears that the debt will become unsustainable as a consequence for example of irresponsible budgetary policies of the country and the debt actually ends up becoming unsustainable because interest rates rise. When these types of crises occur, countries need to contrast the market expectations and restore confidence by taking appropriate policy actions. However, in certain circumstances these policy actions may not be credible unless there is some form of international support for the countries under pressure. Furthermore, the crisis in one country can propagate to other countries. And this leads us to the second issue we will address in this conference.

Safety nets and Liquidity assistance. What type of liquidity support should be provided to a country that has a sustainable debt but which has temporarily lost access to the markets? For this support to be effective two conditions have to be met.

- First, the volume of funds available for liquidity support should be considered adequate by the market. 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. Needless to say, this is highly unrealistic, especially in the European context where creditor countries are usually unwilling to make funds available to countries with structural high debts. Perhaps there is a lot to learn from the experience of the IMF, which has set many rules on the maximum size of the funds to be made available for countries in crisis, even though numerous exceptions to these rules have also been introduced.

- The second condition is that there is no stigma effect. Policymakers usually wait as long as possible before asking for assistance, not to put at risk their political reputation. An instrument which has been introduced to cope with the problem of stigma is that of the precautionary credit lines, i.e. credit lines which countries can use rather freely if market conditions deteriorate. This instrument has been used by the IMF for a number of years and an assessment of its effectiveness can be very useful for the current debate in Europe.

A key issue for Europe will be the definition of the conditions that a country has to satisfy to be eligible for this facility. If they are too tight, they do not solve the stigma problem. If they are too loose, they may not reassure markets about their effectiveness.

Debt restructuring. The most controversial issue is that of debt restructuring. It is a possibility that cannot be ruled out in principle, but which has to be carefully considered for the dramatic economic and social consequences it could have, especially for countries like Italy where most of the debt is held by residents. The debate on this issue regards three aspects. The **when** the **how** and the **who** of a debt restructuring mechanism.

- **When** There is a proposal, mostly made by some Nordic countries, led by the Netherlands, to make debt restructuring an ex ante, almost automatic, precondition to receive support from the ESM. According to them, only the adoption of some strict rules could enhance market discipline and limit moral hazard. The risk however is to transform a poorly managed liquidity crisis into an unjustified solvency crisis. The alternative is to consider debt restructuring as a very last resort option, to be decided on a case by case basis.

- **How** should debt restructuring actually be implemented? In the past, a small number of creditors (with the help of aggressive lawyers) could challenge the agreements reached between the debtor and large groups of creditors on a restructuring process. To limit this possibility, the debt contracts now include Collective Action Clauses which envisage that if a high percentage of creditors agree, with respect to a predefined threshold, all the bonds are to be restructured. The euro area currently has a so called two limb system. A proposal of restructuring requires a vote on the aggregate debt issued by that debtor, as well as on individual bond-by-bond issues. There is now a proposal to move to a single limb CAC which implies to allow only one vote on all of the relevant debt. It seems that there is now an agreement to move to the new system from 2022 on. It will be interesting to assess the impact of this decision on the expectations of investors which are exposed to countries with high debt.

- Finally, **Who** should coordinate debt restructuring, if it will ever occur. This is a thorny issue. The communique of the Eurogroup meeting of last week states that "When appropriate, and if requested by the Member State, the ESM may facilitate the dialogue between its Members and private investors". It is a cautious and ambiguous language which however sets an important precedent. In the past, all the proposals to assign a similar responsibility to the IMF have been rejected because countries were reluctant to surrender their sovereignty on such a delicate issue. Is Europe moving towards a formal sovereign debt restructuring mechanism?