Reforming the Eurozone: Structuring versus restructuring sovereign debts

Guido Tabellini 23 November 2017

In the debate on European reforms, a sovereign debt restructuring mechanism for the Eurozone is often proposed. This column argues that such a mechanism is not required. Instead, Eurozone member states should issue GDP-linked bonds, which would enact an implicit seniority structure on their sovereign debt and make the Eurozone more resilient to the next crisis.

In the debate on European reforms, one often hears the idea that the Eurozone needs a sovereign debt restructuring mechanism (SDRM) (see, for example, the 'non-paper' that was circulated at the latest Eurogroup meeting (Schäuble 2017); also Sapir and Schoenmaker 2017, Weder di Mauro and Zettelmeyer 2017). This idea should be put to rest. There are better and safer ways to cope with the high legacy debts accumulated during the financial crisis.

The arguments in favour of a European SDRM echo an older debate on the role of the IMF. They go as follows. Insolvent sovereign debtors tend to restructure their debt too little and too late. Once they can no longer avoid a default, the negative spillovers force the ESM to bail out the creditors. This in turn creates moral hazard and aggravates over-borrowing by countries with weak institutions. If debt restructuring were easier, it would come sooner and countries would be subject to market discipline. To prevent bailouts, some form of debt restructuring should be a precondition for ESM assistance.

Why the arguments in favour of a European SDRM are wrong

These arguments rest on several wrong premises. First, although there is no doubt that countries engage in excessive borrowing, there is no evidence that this is made worse by moral hazard. The Greek tragedy is there to remind everyone that a debt crisis is devastating, with or without a bailout.

Second, proponents of a European SDRM seem to forget that, unlike emerging countries, most Eurozone countries issue debt under national law. This facilitates debt renegotiation, because domestic courts are partly captive and internalise the interest of their sovereign. Greece was able to achieve debt relief of over 50% on its domestic debt, with the participation of 97% of creditors. Issuing debt under a super-national jurisdiction would offer creditors more protection, not less.

The introduction of collective action clauses (CACs) in the Eurozone public debt is a case in point. After bailing out their banks during the Greek crisis, the governments of Germany and France wanted to show their voters that this would not happen again, and insisted that all Eurozone countries incorporate CACs in their public debt. The goal was to facilitate debt restructuring. They achieved the opposite: CAC bonds yield a lower return than comparable bonds without a CAC. Credit risk was reduced, because CACs removed some ambiguity (Carletti et al. 2017, Gelpern and Gulati 2013).

Third, markets are an imperfect mechanism to discipline sovereign debtors. Markets react too late, and then when they finally do, their reaction is too sudden. Given the size of legacy debts in several countries, automatic restructuring or maturity re-profiling as a precondition for ESM assistance aise global instability. Illiquidity risk would be transformed into insolvency risk, and self- debt runs would become more likely.

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A better way to impose fiscal discipline is to strengthen debt limits and make external institutional constraints more effective. It is not true that the Fiscal Compact is irrelevant. In a country with weak institutions, the threat of falling into an excessive deficit procedure strengthens the hand of the finance minister and can discipline weak coalition governments.

A seniority structure for sovereign debt

This debate is misguided also because it focuses on the wrong issue. The problem is not that public debts are generally too hard to restructure in the Eurozone. The main problem is that sovereign debt does not have a clear seniority structure. If a financial institution becomes insolvent, its liabilities are repaid in a pre-established order of seniority. First losses are born by shareholders, then by holders of convertible debt, and so on. This makes the system more resilient to adverse shocks and reduces the risk of a run on the bank by holders of the more liquid liabilities. Such a seniority structure is missing in the case of public debt, exposing countries with high public debts to additional instability. But a European SDRM does nothing to solve this problem.

GDP-linked bonds

A sovereign cannot issue equity, of course. Some of the benefits of equity-like instrument can be obtained through indexation clauses, however. In particular, bonds indexed to nominal GDP would be de facto junior, and would provide automatic debt and cash relief in the event of adverse shocks or during a crisis.

Both GDP-linked bonds and sovereign debt restructuring would provide debt relief during a crisis. But there are two key differences. First, debt restructuring (as envisaged in current proposals for a European SDRM) would involve all outstanding debt. With GDP-linked bonds, instead, only such bonds would provide debt relief in a recession. The remaining debt would not be affected and de facto it would be senior, and hence more secure. This is an important difference, because the fear of an imminent global restructuring could make a debt run self-fulfilling, while the seniority structure implied by GDP-linked bonds would have the opposite effect.

Second, GDP-linked bonds are very transparent and explicit about the contingencies that trigger debt relief. There is no breach of contract, unlike with debt restructuring. This is vitally important, because breach of contract would have dramatic and lasting consequences on future market access and on citizens' trust in their political institutions. There is also no uncertainty about their enforcement or application. Such contingencies are related to general macroeconomic conditions, and would not be automatically triggered by confidence runs on sovereign debt (except to the extent that such sudden stops would induce a recessions). Incidentally, this too would reduce the likelihood of self-fulfilling debt runs or sudden stops.

Although GDP-linked bonds are rare, several economists have advocated their use (Blanchard et al. 2016, Shiller 2003, and a recent conference at the Bank of England). One problem is that they are illiquid, and hence costly for the borrower. But liquidity is endogenous and depends on the size of the market. If all Eurozone countries agreed to issue them regularly and with identical provisions, the liquidity premium would come down and they may become worth issuing.

Even if liquid, GDP-linked bonds would carry an insurance premium, and this would make them costly for the borrower. This fact can be exploited to discourage excessive borrowing, however. For instance, one may require that new debt in excess of some pre-determined path should take the form of GDP-linked bonds. This would implicitly make the excess debt junior relative to the pre-existing stock, increasing the incentives for debt reduction, while at the same time implementing a debt structure that is more resilient to economic crisis.

Concluding remarks

The first priority of any Eurozone reform should be to reduce the risk of another financial crisis. Debt restructuring is an event with enormous economic, social, and political implications. It should be exercised under political discretion, and not subject to automatic mechanisms. Nevertheless, the Eurozone needs a more resilient structure for its high sovereign debts. GDP-linked bonds provide automatic debt reliefs during economic crisis. Now is the time to consider this option.

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