Policy Exchange

research note
March 2012

Sovereign Default

Lessons for Europe from Argentina's default

James Barty

Executive Summary

Sovereign default has become a reality in Greece with profound implications for the rest of the Euro Area and the international financial system. This paper looks at what lessons can be learnt by examining the last major sovereign default in Argentina 2002. It argues that it is risky to treat investors unfairly as it can lead to countries being locked out of international financial markets with adverse consequences for their eventual recovery. Despite the political pressures to punish investors they need to be treated fairly to limit the adverse consequences, both immediately in terms of other vulnerable countries and in the future for the return of defaulted states to the financial markets.

- Many have advocated default and devaluation for Greece, often highlighting Argentina as an example of how this can lead to a recovery in the economy. Yet Argentina is still locked out of international markets a decade later, care of its forced default, has high inflation and owes much of its recovery to the global commodity boom. Greece cannot hope for such a miracle.
- Argentina did not negotiate with its investors but offered a take it or leave it default. It still has not settled with a significant minority of investors or the Paris club of sovereign creditors. It also refuses access to the IMF to undertake an Article IV review of its economy. Many suspect this is because Argentina has systematically understated inflation in its official statistics, which has resulted in underpayment of its inflation-linked bonds.
- For a member of the G20 this is remarkable behaviour. In this paper we advocate that the global authorities more rigorously enforce available sanctions against countries that persistently violate international conventions. Specifically in Argentina's case we suggest i) opposing further loans from the IDB and World Bank ii) insisting on an Article IV IMF review and iii) enforcing a deferral of any Paris Club agreement until Argentina has moved to solve all outstanding financial obligations (both public and private). With sovereign defaults seemingly about to become more common it is important that all countries are aware of their responsibilities and the costs of ignoring them.
- Sovereign default in the Euro Area is now a reality with Greece writing down private sector debts by around 75%. The Greek default has seen many twists and turns, including an attempt

by Euro Area authorities to make it "voluntary" and hence prevent a triggering of credit default swaps. We believe this was a mistake because it undermined the insurance bondholders had sought and led to forced selling of other euro area sovereign bonds, including Italy and Spain. The positive is that, unlike in Argentina, investors were negotiated with and are now being protected by a ringfencing of loan repayments. CDS has also been triggered[1] through the use of collective action clauses, so as to ensure as many bondholders as possible participated in the restructuring. In contrast to official concerns we believe the triggering of CDS is a good outcome because investors can now trust their insurance.

- The key message for Greece from the Argentinian experience is not that a compulsory default and devaluation is necessarily the way out. It is, in contrast, that you need to be transparent and maintain the sanctity of contract law. Only in that way can Greece maintain the trust of investors, which is necessary to allow an eventual re-entry into financial markets. Punishing investors can look like good politics in the short term. Yet it risks deterring not just financial investors, but more importantly the commercial investors that Greece needs if its economy is to have a chance of recovering.

Introduction

The crisis in the Eurozone has finally culminated in a sovereign default with Greek debt to be subject to a substantial haircut as the European authorities and the International Monetary Fund (IMF) seek to bring Greek indebtedness down to a more sustainable level. The issue of sovereign default is not a straightforward one. If a company goes into default there are various mechanisms to protect both stakeholders and creditors, be it Chapter 11 in the US or pre-packs in the UK. Not all of these mechanisms are liked by all sides, with creditors and suppliers having recently criticised pre-pack laws in the UK as being too favourable to existing stakeholders and too harsh on creditors.[2] Nevertheless, at least the process is transparent and the rule of law has to be followed or parties can seek redress in the courts. Sovereign defaults are nowhere near as straightforward or transparent, as we are currently seeing with Greece.

The Greek situation has been complicated, not just because the fiscal situation has continually deteriorated, but also because the EU authorities, led by the ECB, tried to avoid a compulsory default. This was driven by a fear of a repeat of the Lehman's fallout on financial markets stemming from the default and a desire amongst some elements to avoid "rewarding" speculators. What might seem

[1] http://news.yahoo.com/isda-declares-greek-credit-event-cds-payments-triggered-200404200.html

[2] Pre pack administrations involve the sale of a business before it enters insolvency proceedings. Normally providing for a write down of creditors in order to maintain the business as a going concern. The Telegraph (January 26 2012) http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9042682/Pre-pack-administration-overhaul-dropped.html

desirable from a political point of view may, however, have adverse consequences. First, by seeking to not trigger Credit Default Swaps (CDS) last summer politicians may have prompted investors merely to sell their government bonds, not just in Greece but also Italy, Spain and Portugal, as the insurance was no longer seen as reliable in the event of a problem. While it may not have been the only reason for the wave of selling of other peripheral government bonds last year we believe it is no coincidence that it happened after it became clear that a voluntary writedown of Greek debt was being sought, with the explicit objective of avoiding a triggering of CDS. If, as an investor, you cannot be sure that your insurance will pay out you have to reduce your gross exposure.

Despite all of these efforts to avoid a "default", CDS was eventually triggered as the Greek government introduced retrospective Collective Action Clauses (CAC) in order to compel investors to participate in the restructuring whether they liked it or not. These CACs are not going to be applied bond by bond (as is usually the case) but across the entire bond stock, reducing the leverage of investors in any negotiation. While it may seem a good idea to ensure that all investors end up with the same terms, there is a risk that it will deter investors from buying government debt in the future, thereby prolonging the suspension of countries from international debt markets. It would also likely make funding of banks and direct investment into those countries less attractive if it was felt that governments could retrospectively change contract law as it suited them.

Although the Euro Area default is a step into the unknown we can draw on lessons from defaults elsewhere. In this paper we look to the experience of Argentina. It too cajoled investors into accepting writedowns and debt exchanges that were adverse. Argentina went one step further in refusing to negotiate with investors and effectively repudiated its debt. After offering investors a debt exchange on a "take it or leave it basis" it then introduced the "lock law" forbidding the government from offering any better terms to investors who had refused the offer. It is widely accepted that Argentinian statistics have been distorted to reduce returns to investors who have held inflation linked bonds. It has refused to honour court judgements and arbitration awards won by investors and has insulated its reserves and other sovereign property by moving them to jurisdictions where creditors could not reach them. The result is that it has effectively been locked out of markets for a prolonged period of time. While some, such as Nouriel Roubini,[3] cite Argentina as an example of a successful recovery from default it is our view that any successes have come in spite of its approach to default (and were mostly due to the boom in commodity prices) and not because of it.

It is crucial that any default of a sovereign nation, although always painful, is carried out in a manner that is fair to all investors and obeys international conventions and laws. We believe that governments

[3] Financial Times, September 2011 Roubini argued that "Greece must now begin an orderly default, voluntarily exit the Eurozone and return to the Drachma".

should consider strengthening the sanctions for errant behaviour that flouts international conventions, particularly when countries are in breach of IMF regulations and judgements have been made against them in international courts, as in the case of Argentina. This is important for the UK both in its role as a major financial centre and a centre for international law, particularly as the new Greek bonds (which will replace those defaulted on) will be governed by English law. Many of the Argentinian bonds and loans were drawn up under New York law which has subsequently been ignored.

Those who argue that default is an easy way out are, in our opinion, mistaken. Default undermines the confidence of investors, both financial and also commercial. Foreign direct investment in Argentina was badly hit in the aftermath of their default. Greece will need such investment more than ever in the years ahead as it seeks to increase the productivity of the private sector. Commercial investors, as much as financial investors, need to be confident that they can trust a government to deliver on its responsibilities and that the rule of contract law, in particular, continues to be enforced. If they feel they cannot trust a government then the investment will dry up and the chances of a sustainable recovery will be reduced still further. Greece cannot afford for that to happen.

The default in Greece is seen as the forerunner of whatever else is going to happen in the Euro Area. There have been many errors on the way, but at least the sovereign negotiated with investors to try and find a solution acceptable to as many investors as possible. It is vital that, now this is done, Greece and the Euro Area do not return to the private sector for more writedowns. From that perspective we applaud the decision to ringfence money to repay the debt. If investors feel they can be tapped for ever greater contributions from a default not only will they be reluctant to ever fund Greece again in the future, they will also extrapolate the outturn to other vulnerable euro area nations. That is not something the Euro Authorities can afford right now.

Argentina – a lesson in how not to do it[4]

The Default

Argentina defaulted on its debts in December 2001 and shortly afterwards abandoned the peg of the Argentinian peso against the US dollar. In many ways the economic situation was not dissimilar to Greece in that Argentina had sought a hard currency peg as a way to bring inflation down and discipline to its economy. It did benefit from a drop in interest rates and perceived increased credibility. The peg also allowed it to lower its borrowing costs by borrowing in foreign currencies (mostly the dollar). When economic conditions deteriorated and the perception began to develop that the currency might be

[4] Unless stated otherwise, all monetary figures and statistics in the section "Argentina – a lesson in how not to do it: The Default" taken from Hornbeck, J. F. (July, 2010). *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"*. Congressional Research Service

overvalued several bouts of tough austerity measures were implemented.[5] In 2000 for example spending was frozen and retirement benefits were cut, while emergency funding from the IMF was used to bridge the gap. In the end, with capital flight an increasing problem and the public rebelling against the measures, the resolve of the politicians gave way and declared default, abandoning the peg shortly thereafter.

There are many differences between the Argentinian example and the current Greek situation, which we will highlight later in this report. However, there are sufficient similarities for the comparison to be worth making. Worryingly there remain many issues outstanding or Argentina more than a decade after the initial default.

At the time of default the government owed \$81.8 billion to private investors, \$6.2 billion to the Paris Club[6] countries and \$9.8 billion to the IMF. The de-pegging of the peso to the dollar and consequent capital flight led to a collapse in the economy. The government argued (with echoes of the Greek situation today) that bondholders had to accept a marked writedown in their holdings to share in the pain.[7] Sovereign debt restructurings have normally been consensual, as is the case with Greece now, with governments and creditors coming to an understanding, even if the process can take some significant amount of time. Frequently the process involves a writedown in the face value of the debt, replacing it with new debt with lower interest rates and longer maturities. Previous restructurings[8] had typically seen a greater than 90% participation rate with agreement to pay back at least a 50% of the net present value of the debt.

The restructuring process began in 2002 and negotiations with the IMF and private investors continued for some three years. Argentina took a hard line, insisting on a large writedown for private investors and suspending action on both the Paris club and IMF debt. With negotiations reaching an impasse Argentina decided to go it alone and file for a one time unilateral offer to creditors. The government also passed legislation that became known as the 'Lock Law', which prohibited a reopening of the exchange or making any future offer on better terms. The offer was opened on January 14, 2005, with \$81.8 billion of debt plus \$21.4 billion of past due interest being offered for conversion into new debt at a net present value of just 30%. Such a low level of net present value was deemed to be unduly

[5] http://en.wikipedia.org/wiki/Argentine_economic_crisis_(1999–2002)
[6] The "Paris Club" refers to a group of 19 creditor nations who voluntarily agree to take a common approach in negotiating debt relief for developing countries unable to meet external obligations. The 19 participating countries agree to work on a case-by-case basis when restructuring and/or reducing official debt owed to them if certain conditions are met.
[7] A writedown is where creditors have to accept only a partial repayment of their debt. In both Argentina and Greece investors look set to be repaid only around 30% of the original value of their debt. The Economist (March 3 2005) http://www.economist.com/node/3715868
[8] For examples of five developing country defaults (Ecuador, Pakistan, Russia, Ukraine, and Uruguay) that had participation rates of 93%-98%, see Marcus Miller and Dania Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," The World Economy, vol. 30, no. 10 (October 2007), p. 1497.

aggressive by a number of creditors, leading to some $19.6 billion of bonds (24% of those eligible) not being tendered.

In 2006 Argentina agreed to repay the IMF in full for the $9.8 billion it was owed.[9] As for the Paris club debt this was remained unpaid and the holdout investors were left out in the cold. Many of these sought repayment through litigation. There were a number of successes for these holdout investors, particularly in the US courts, with judgements and attachment orders (where investors could potentially seek to claim repayment on new money raised by Argentina) granted. The total of these legal judgements now stands in excess of $8.5 billion.[10] This effectively locked Argentina out of financial markets. It has managed to survive despite this largely because of the strong commodity boom, which led to a surge in exports and hence demand for its currency. While others allowed their currencies to appreciate, Argentina chose instead, through aggressive intervention, to rebuild its foreign exchange reserves.

Many investors sought to challenge the Argentinian action because it set an uncomfortable precedent. Either they accepted the offer and took a very large 'haircut' or they rejected it with no compensation at all. In addition to defaulting on the bond debt, Argentina breached contractual obligations with foreign direct investors, leading to many investment disputes being filed at the World Bank's International Centre for the Settlement of Investment Disputes (ICSID). Awards have totalled more than $900 million, none of which have been paid out as Argentina refuses to abide by the rulings.[11]

Argentina's refusal to pay lawful judgements and awards or negotiate their resolution, has resulted in the country's effective exclusion from international capital markets. This is because creditors with final judgements could attach the proceeds of a "new money" bond issue (in other words try to claim repayment out of the new money). Moreover, Argentina's longstanding default on its Paris Club debt has resulted in creditor countries withholding export insurance and financing guarantees – a serious impediment to foreign direct investment. And finally the US has voted against a disbursement of funds from some multinational institutions, such as the World Bank, because of Argentina's refusal to honour judgements and awards against it.

In 2010 Argentina came back to investors with a second exchange programme on terms that were worse than the 2005 exchange. This programme attracted a further $12.86 billion of eligible debt taking the total amount of debt restructured up to 92.6% of the outstanding bond debt at the time of the default in 2001. Approximately $6 billion of defaulted bonds remain outstanding, on which creditors continue to pursue the Argentinian government in the courts.

[9] The Guardian (December 19 2005) http://www.guardian.co.uk/business/2005/dec/19/argentina.internationalnews
[10] Sandy, C. (July 2011). *Argentina: It is really all about politics*. Credit Suisse Economics Research, p.9
[11] Merco Press (November 16 2011) http://en.mercopress.com/2011/11/16/us-will-keep-reminding-argentina-it-must-comply-with-international-obligations

In 2006, the Argentinian government began intervening in the management of INDEC, the official statistics agency. Specifically, INDEC adopted a new methodology of measuring inflation, which has resulted in consistent understatement of this key indicator.[12] Since much of the government's peso denominated debt is indexed to inflation, Argentina has been underpaying holders of these bonds. As of the date of publication the IMF has given Argentina six months to get its statistics in order or face sanctions.[13]

Figure 1. Argentinian Peso vs US Dollar

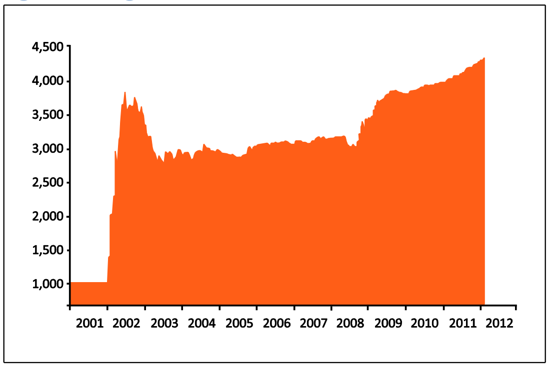
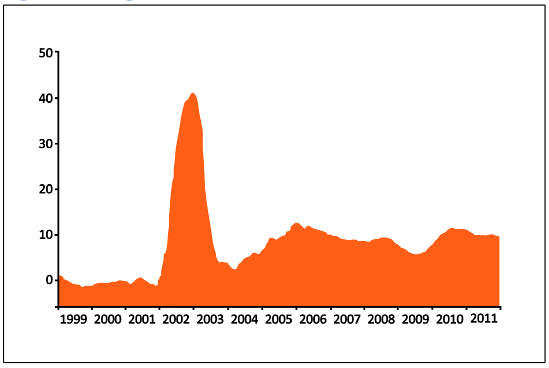


Figure 2. Argentinian CPI inflation



Source: Bloomberg

The economy and the consequences of default

In defaulting and then being locked out of financial markets Argentina had to undertake a model of growth that was heavily dependent on a deep devaluation of its exchange rate (see chart 1 above). The peso dropped from parity against the dollar to around 3 pesos to the dollar from 2003 until 2008 before depreciating again in the aftermath of the financial crisis to stand around 4.33 at the time of writing. Not surprisingly the initial devaluation caused a major spike in inflation despite an economy that was contracting at an annual rate of around 15%. The economy did recover and inflation did stabilise, although there is much disagreement about the rate at which it has settled. Official statistics suggest it was around 9-10%, whereas private estimates suggest it may have been more like 20%. The difference between the two is, of course, enormous. The first would suggest a successful exit from the default, the other would suggest it has been much more problematic.

The commodity export boom has been the key economic saviour with exports quadrupling to their peak last year.[14] Much of that was a function of the global commodity boom, which drove prices markedly higher, with Argentina being highly fortunate in the timing of its default. That boom and the revenues from it allowed the government to transfer some of that prosperity more broadly. Civil service

[12] The Argentina Independent (April 27 2011) http://www.argentinaindependent.com/currentaffairs/newsfromargentina/price-check-imf-reviews-official-inflation-data/

[13] Hornbeck, J. F. (July, 2010). *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"*. Congressional Research Service, p.8.

[14] Focus Economics http://www.focus-economics.com/en/latin-america/argentina/economic-indicators/2011/2011-07-22-exports-rise-above-pre-crisis-peak.html

employment has risen by one third from the start of the crisis, while subsidies to consumers and other forms of social spending have both risen by around 3 percentage points of GDP. This has led to unemployment falling to around 8%.

Accordingly Argentina has spent much of its windfall, with the result that the government has had to force the central bank on several occasions to transfer its currency reserves to government in order to meet the country's foreign currency liabilities. Indeed, the raids on the central bank have not been the only methods for the government to raise money. The country's private pension funds were nationalised in late 2008[15] and have subsequently become the very significant buyers of government bonds, so that these now count for some 50% of their assets. This makes these pension funds vulnerable, particularly if the true inflation rate is much higher than the official one.

Figure 3. Argentinian GDP growth % yoy

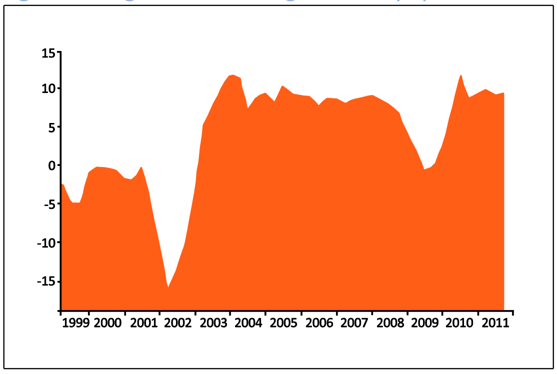
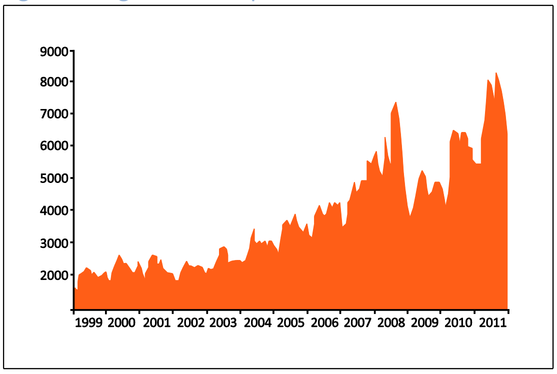


Figure 4.Argentinian exports USD millions



Source: Bloomberg

In some ways Argentina had little choice but to follow this path once it had locked itself out of financial markets. Foreign direct investment collapsed, in part because of the uncertainty over the economy, but also due to concerns about whether any profits from those investments could be taken out of the country. So a policy of generating large currency reserves (by intervening to hold its currency down) and using the gains from commodity prices to inflate the rest of the economy was perhaps the only real one available. That is not to say it is ideal since it has arguably left the economy with a bloated government sector and consumers dependent on government subsidies and transfers. That is all possible while the boom continues but it is not a long term strategy.

The fallout for Argentina

Argentina appears to have emerged from a sizeable default with an economy that has recovered and indebtedness that has fallen. For some that makes it a model of why a default that forces deep haircuts on creditors can work. More likely Argentina has been fortunate in its timing. Recently the government has prevented foreign oil companies from repatriating revenue from sales, forced insurance companies

[15] The New York Times (October 21 2008): http://www.nytimes.com/2008/10/22/business/worldbusiness/22argentina.html

to bring money invested abroad back to Argentina and imposed new requirements on importers,[16] suggesting that even the commodity boom has had its limits in bailing Argentina out.

The fact that it has lost numerous court cases against holdout investors, which means that there is an ongoing risk that any money raised in the capital markets could be seized, continues to freeze Argentina out of international capital markets. This has prompted Argentina to resort to the creative, unorthodox financing methods detailed above.

If Argentina is to re-enter financial markets it must take the following steps:

1. Negotiate a deal with private sector holdouts. Without this it will continue to run the risk of any new financing proceeds being seized.
2. Repay or reschedule the Paris Club debt. The convention is that sovereign nations honour the debt owed to other sovereign nations, even if it has to be restructured. Argentina has chosen to ignore this convention.
3. Re-engage with the IMF. In particular Argentina needs to agree to an Article IV review of its economy. This would provide an unbiased assessment of the country's economic health and ability to repay its debts. This is also normally a pre-requisite for any Paris club restructuring of debts. Argentina though continues to regard the IMF with a large degree of mistrust given the problems over IMF policy prescriptions in the run up to a default. It would also have to agree to an independent assessment of its inflation statistics, presumably opening itself up to further legal action should it be shown to have misreported the true inflation rate.

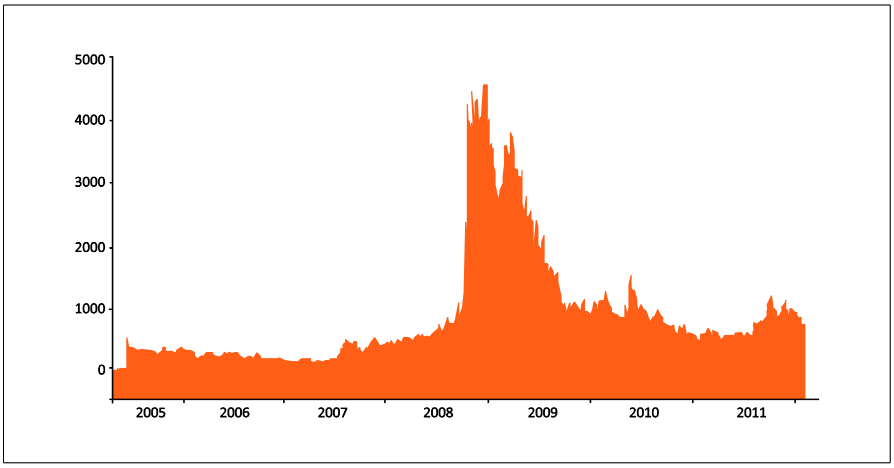
We believe that the G20 governments, including the UK, should consider how they could increase the pressure on Argentina to take such steps. We believe they could do so by i) opposing further loans to Argentina from the World Bank and IDB ii) urging the IMF to insist on an Article IV review and iii) insisting on a deferral of any Paris Club agreement until Argentina has moved to solve all outstanding financial obligations (both public and private).

Argentina has also attracted criticism for its repeated stalling in the implementation of safeguards and enforcement of AML/Terrorist Financing measures as required by the Financial Action Task Force, to the point where it is now assigned to the "Grey List" of countries with "strategic deficiencies" in their financial systems.[17]

---

[16] Merco Press (October 27 2011): http://en.mercopress.com/2011/10/27/argentine-insurance-companies-ordered-to-repatriate-foreign-investments
[17] American Task Force Argentina (June 28 2011): http://atfa.org/cgi-data/press/files/62.shtml

Figure 5. Argentina 5 year USD CDS spread



Source: Bloomberg

Argentina, as we have noted, does pay a price for this in being excluded from financial markets. Any attempt to re-enter credit markets before settling its outstanding debts would be risky because of the possibility of attachment (where courts can seize proceeds from new debt to repay outstanding debts) and potential investors would likely demand a premium for that. While CDS spreads for Argentina are some way from their 2008 highs, at close to 750bp (see chart above) they are still considerably higher than they arguably should be for a country with a current account surplus and falling indebtedness. In rating Argentina at single B in 2010 Fitch said that Argentina's rating is heavily constrained[18] by "inconsistent policies" that have accelerated inflation and economic volatility. Indeed, on the basis of its per capita income Argentina would typically have a rating of BB or better. Countries with such ratings tend to have considerably lower spreads. Only by settling these outstanding issues once and for all can Argentina hope to attract that lower credit spread.

These are the main costs for Argentina. That Argentina has flouted most of the conventions of international finance when it comes to default, with little sanction outside of that which holdout investors have exercised through their court action, should be a concern, we believe, for the international financial community and governments alike. This is particularly the case with more sovereign defaults seeming likely. Argentina is now in a position, care of its recovery, to settle its outstanding debts to both the holdout investors and the Paris Club. It should submit to an Article IV IMF consultation to ensure that investors can have faith in its statistics.

We believe there are a number of sanctions that could be considered for countries, like Argentina, that flout their international obligations. Chief amongst these should be suspension from multi-lateral international bodies. Argentina is, for example, still a member of the G20. This appears bizarre when it will not submit itself to an IMF assessment of its economy and it continues to have deficiencies in its money laundering and terrorist financing safeguards. Access to funding from multi-lateral bodies should

[18] http://www.businessweek.com/news/2011-11-02/argentina-s-credit-rating-heavily-constrained-fitch-says.html

also be curtailed. That would preclude any further World Bank and IDB lending to Argentina. At the moment the US seems to be the only country to be supporting such a line. By showing that a defaulting nation has to respect the principles of international finance then it sets the right example for those countries that now have to consider the path of default.

What does this all mean for Greece and the rest of the euro area?

One of the reasons we chose Argentina as a case study when considering Greece is because there are significant economic similarities and a default is considered necessary to bring down the level of indebtedness. Even similar language has been used of private creditors having to take their share of the pain.[19] However, there are two glaring differences. First Argentina imposed the writedown on investors with no consultation. Second it had the benefit of a global commodity boom to reflate its economy after the default.[20] Unless something very bizarre happens Greece, or indeed any other Eurozone country which might experience default, is unlikely to be anywhere near as lucky. That in turn makes it all the more important that when going into default a country, and the institutions working with it, does as much as possible to keep investors onside. That would allow foreign direct investment to continue, allow their banking system to fund and eventually allow the sovereign to return to markets, as soon as fundamentals allow. The alternative as in Argentina is years of legal wrangling and sustained isolation from financial markets.

Figure 6. Greek GDP growth %yoy

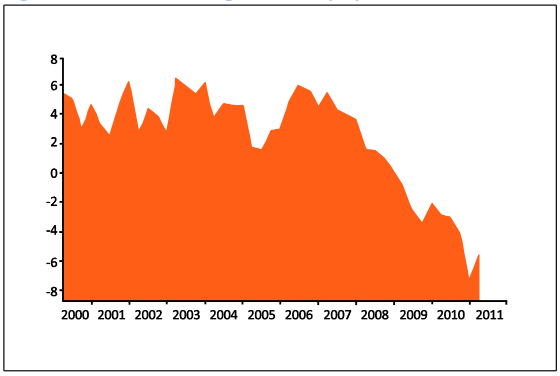
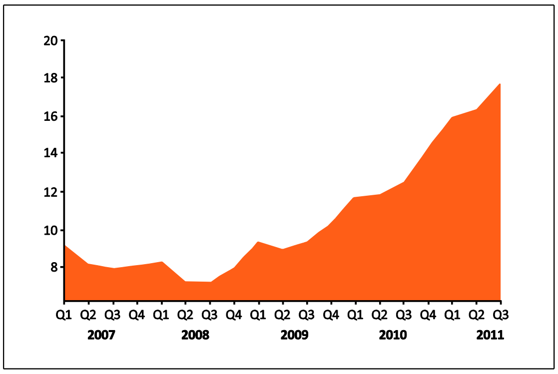


Figure 7. Greek unemployment %



Source: Bloomberg

The case of Greece

As we noted earlier the problems in Greece were of similar origins to Argentina. In both cases there was a decision to peg its currency (in Greece's case via a monetary union) to a harder currency, with the objective of gaining lower interest rates and credibility. There are some similarities too in the distortion

[19] Associated Press (June 16 2011): http://en-maktoob.news.yahoo.com/germany-private-creditors-must-share-greek-pain-141010384.html
[20] The Centre for International Governance Innovation (December 13 2011): http://www.cigionline.org/publications/2011/12/greece-2011-argentina-2002-redux

of statistics since it is now believed that Greece never really met the Maastricht criteria for entry into monetary union.[21] Moreover, the statistics were sufficiently poor that the full extent of the problem was disguised until a change of government in 2009[22] (Argentina in contrast distorted its statistics after the default). With successive Greek governments having failed to address the structural weaknesses of the economy, such as a low tax take, unduly generous pensions and stubbornly high inflation, Greece was left with an economy ill suited to cope with the recent global economic turmoil.

Greece finds itself today in an incredibly difficult position. According to the IMF, Greek debt as a percentage of GDP likely reached 160% last year (some €350 billion), with a fiscal deficit of around 9% of GDP (almost €20 billion), down from almost 16% in 2009 but still way above anything that is needed to stabilise the debt situation. Indeed, there was still projected to be a primary deficit (that is before interest payments) of around 2.3% last year. Although the projection is for the primary deficit to be eliminated this year, that is dependent on further austerity measures. The economy shrank by around 6% last year (the fifth successive year of decline), which makes such measures difficult to agree as we have been seeing with the political wranglings of recent months. Without dramatic changes both the economy and fiscal position are in danger of spiralling out of control. Moreover, to underline the poor competitive position of the economy the current account deficit is still running at around 10% of GDP, despite the ongoing deep recession.

The IMF believes that, for Greece to attain a sustainable position in terms of debt to GDP, the ratio has to be stabilised at around 120% of GDP.[23] Even with current austerity measures, that is deemed to be implausible without a significant writing down of the current debt stock. This is what lay behind the Private Sector Involvement (or PSI) in the writing off of debt. The plan is for existing bonds to be exchanged for Greek government bonds with a face value of 31.5% of the value of the bonds exchanged, plus notes of the EFSF (European Financial Stability Fund) with a face value of 15%. The EFSF notes will mature in 2 years whereas the Greek bonds will mature in 2042. The net present value writedown is estimated to be around 75%.[24] In other words the proposed reduction in debt is similar in magnitude to that seen in Argentina.

---

[21] BBC News (February 3 2012): http://www.bbc.co.uk/news/world-europe-16834815
[22] BBC News (November 30 2009): http://news.bbc.co.uk/1/hi/business/8387190.stm
[23] International Monetary Fund (December 2011), Country Report No. 11/351
[24] http://www.emg.rs/en/news/region/175146.html

Figure 8. Greek debt to GDP %

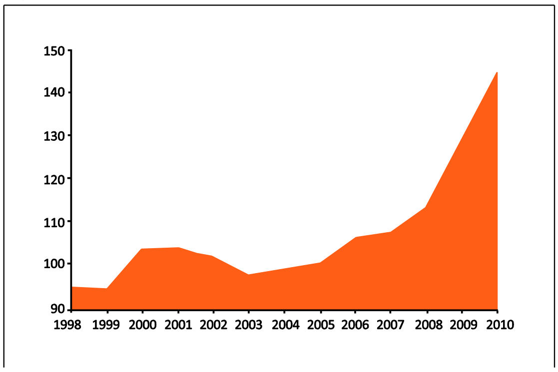
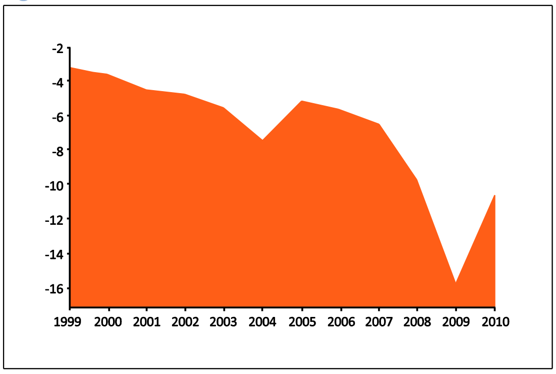


Figure 9. Greek fiscal deficit % GDP



Source: Bloomberg

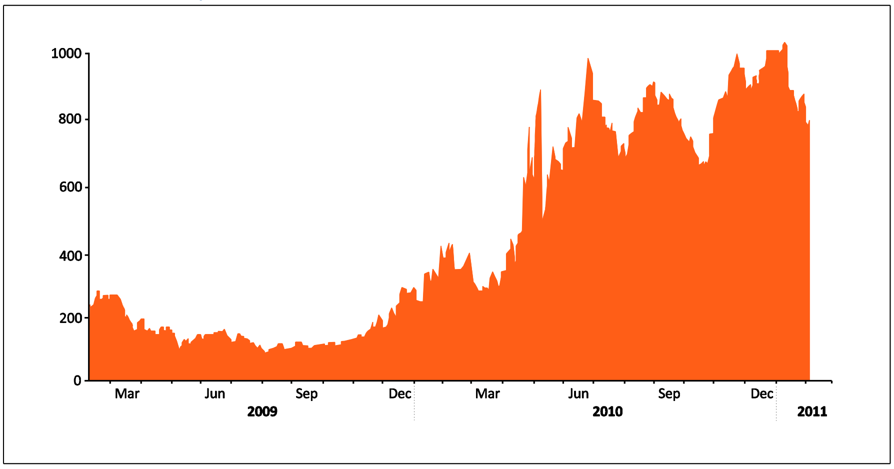
While it is understandable that a write down of privately held government debt has been sought by the Euro Area and IMF as part of the restructuring, the process has not been as transparent and equitable as it could have been. For example, by seeking a "voluntary" restructuring that would not trigger CDS the authorities caused significant uncertainty for investors. Many investors, including banks, had sought to hedge their Greek exposure through CDS. By seeking to not trigger the CDS the European politicians arguably aggravated the situation forcing investors to sell their bonds rather than hedge them.[25] We believe it is no coincidence that the wave of selling of Italian and Spanish government bonds last summer started at the time of the move to a voluntary restructuring of Greek debt, although other elements such as a proposed ban on sovereign CDS would likely also have been a factor. If investors cannot count on their insurance paying out when the bond defaults the only alternative is to sell those bonds instead. Indeed, there were rumours of some regulators telling their banks that they would assess their bond portfolios on a gross not net basis in the aftermath of that decision. In other words they no longer considered a CDS hedge to be reliable. Any such ruling by a regulator would almost automatically trigger a sale of existing bond positions, as banks sought to bring their gross and net positions closer into line.

While there has to be some concern about the outcome of a formal default because of what happened after the failure of Lehmans in 2008, it always seemed unlikely to us that the fallout would be anything like the same, at least directly. This is because this default has been on the cards for such a long time. The chart below shows that Greek 5 year CDS had reached 1000bp by the end of 2010, a sure sign that the market was pricing a high probability of default. By the time of the decision to involve the private sector formally last summer it had already reached 2000bp. In late February ahead of the default it was over 6000bp. So, unlike in the Lehmans case, the market has been warned and institutions have had plenty of time to get themselves ready for the outcome. Ironically, the use of retrospective CACs to coerce remaining investors into accepting the terms was deemed to trigger the CDS in any case. The fall out seems to have been pretty minimal with global financial markets actually making news highs post

[25] Gillian Tett in the FT (November 17 2011): http://www.ft.com

the announcement of a credit event[26]. In our opinion the authorities would have been much better advised if they had not tried to avoid triggering CDS in the first place.

Figure 10. Greek 5 Year CDS Spread



Source: Bloomberg

That is not to say that a voluntary default is not the right way forward. It probably is, as long as a high degree of acceptance can be obtained (as was eventually the case in Greece). After all in Argentina's case it was a compulsory default with no negotiation. At least by striving to include as many investors as possible to agree on the terms of the write down, then the authorities reduced the risk of the credit event being disorderly. As a result it is more likely that Greece will be welcomed back into financial markets at some point in the future are increased.

The collective action clauses were enacted into law by the Greek parliament in late February and applied to the 90% of outstanding bonds that were governed by Greek law. Such actions are with little precedent and run against almost all contract conventions. Simply put it is akin to two parties signing a contract and then one of the parties unilaterally changing the terms of that contract in its own interests some time later. Moreover, as we have noted above the CACs will, unusually, apply to the entire bond stock rather than an individual issue to ensure investors have little ability to demand better terms. We do understand the need to ensure that the restructuring is not held up unnecessarily, but would argue that the authorities need to tread carefully. They need to be seen to be upholding the rule of law, otherwise investors, be they financial or commercial, are likely to think twice about investing in the country in the future.

If, for whatever reason, this is not the perception then investors will immediately assume that any adverse treatment in the Greek bond market would be applied to them in any future restructuring. Again, like the decision to try to not trigger CDS, it could lead to a renewed wave of selling of euro area government bonds. The good point here is that at least investors were consulted and negotiated with in setting the terms of default. There have been significant concessions by investors with a very sizeable

[26] Greece's Credit Non-Event The Wall Street Journal March 12th, 2012
http://online.wsj.com/article/SB10001424052702304537904577275462837459448.html

writedown of the debt in net present value terms. We believe that the writedown has gone as far as it is reasonable to go, without triggering a major revolt from investors.

Even the writedown of private sector holdings was unlikely to be sufficient to achieve the IMF's target of a 120% ceiling for the debt to GDP ratio. The ECB at one point was demanding that it be paid out in full on its holdings. It is estimated that the ECB holds some €40 billion of Greek government bonds, which, were they to have been redeemed at par would have yielded a €15 billion profit. Sensibly the ECB agreed to sell those bonds back to the EFSF and Greek authorities at cost. To have done otherwise would potentially have undermined the ECB's own actions in intervening in the market, since the greater such purchases are the bigger any eventual private sector write down would have to be to achieve the same reduction in total indebtedness. The ECB has still walked away with a considerably better deal than the private sector investors.

We believe this was a good step forward, as was the proposal for a separate fiscal account[27] to be set up to ensure the repayment of debts in the future. This will take the private sector out of the risk of a second round default by the Greek government. In so doing it reduces the use of such a threat as a bargaining tool by Greek politicians in future and ensures that private sector creditors cannot be written down again. Given the use of retrospective CACs and the premium paid to the ECB this would seem only fair.

The question may well be asked as to why we should want to show fairness to private sector investors in such a situation. It is easy to make the argument that "they bought the bonds so they should pay the price". However, as we saw with Argentina if you breach the trust of investors it is much harder to come back to market. This is important not only for when financial investors are asked once again to fund Greek debts but even more importantly for commercial investors who it is hoped will continue to invest in the Greek economy. Private sector investors are accepting that they have to be written down in order for Greece to have a chance to restructure and recover, but it needs to be seen to be just and equitable, not changed on the whim of a politician. The more the European authorities and the IMF can be seen to be doing this in the case of Greece the less adverse fall out there is likely to be elsewhere in the Euro Area.

Conclusion

A default of a sovereign nation is something is only ever a last resort, normally coming at a time of extreme economic and financial distress. As a result the political pressure to extract the maximum concession from (and sometimes even to punish) private investors and to make decisions which are inequitable is likely to be very high. Notwithstanding these pressures it is important that a default is carried out in as fair a manner as possible. Failure to do so not only can reduce the chances of an

[27] Bloomberg (February 6 2012) http://www.bloomberg.com/news/2012-02-06/merkel-sarkozy-weigh-setting-up-separate-account-for-greek-debt-payments.html

eventual return of the defaulting state to financial markets, it can also in the case of the euro area potentially trigger destabilising investment decisions. The exodus from other peripheral bond markets after the decision to try and avoid triggering CDS in Greece is the clearest example of such an outcome.

The eventual solution in Greece of consulting investors and agreeing a deal (albeit a harsh one) was the right approach. In the end CDS were indeed triggered (albeit through the use of retrospective CACs), something which we believe can be viewed as a positive, not a negative, because it does at least mean that the insurance will pay out. Given the enormous writedowns experienced by private sector investors, it is right that they are being protected through a segregation of funds to pay back existing debtors.

With the re-emergence of sovereign default as a reality we also believe it is important that international rules governing default (and the consequences from breaching them) are actually strengthened at this time, to remind countries that there are benefits from behaving correctly even in the most difficult circumstances. Some have advocated that Greece should follow Argentina's example through leaving the Euro, devaluing and defaulting on its debt at the same time. That would be an incredibly risky thing to do. Argentina escaped more by luck (through the commodity boom) than by design. Yet the fact that Argentina has, thus far, not been held to account because it has been allowed to ignore the courts, the IMF and its obligations to creditors has created a dangerous precedent. Making it clear even now, a decade later, that there are costs to bad behaviour would be a significant step forward.

Policy Exchange

research note
March 2012

The work of the Economics & Social Policy Unit at Policy Exchange

For more information on the work of the Economics & Social Policy Unit, please contact Matthew Oakley, Head of Economics & Social Policy at matthew.oakley@policyexchange.org.uk.

About Policy Exchange

Policy Exchange is an independent educational charity. Our mission is to develop and promote new policy ideas which will foster a free society based on strong communities, limited government, national self confidence and an enterprise culture. In contrast to many other think tanks Policy Exchange is committed to an evidence-based approach to policy development. Our impact speaks for itself: from housing to policing reform, education to the NHS, our proposals have been taken on board by the main political parties. Registered charity number 1096300.

For more information please contact us at: Clutha House, 10 Storey's Gate, London, SW1P 3AY. Alternatively we can be contacted on 020 7340 2650 and at info@policyexchange.org.uk

Trustees

Daniel Finkelstein (Chairman of the Board), Richard Ehrman (Deputy Chair), Theodore Agnew, Richard Briance, Simon Brocklebank-Fowler, Robin Edwards, Virginia Fraser, Edward Heathcoat-Amory, David Meller, George Robinson, Robert Rosenkranz, Andrew Sells, Tim Steel, Rachel Whetstone, Simon Wolfson.