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Responses to potential national insolvency

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The Global Polity

Responses to Potential National Insolvency

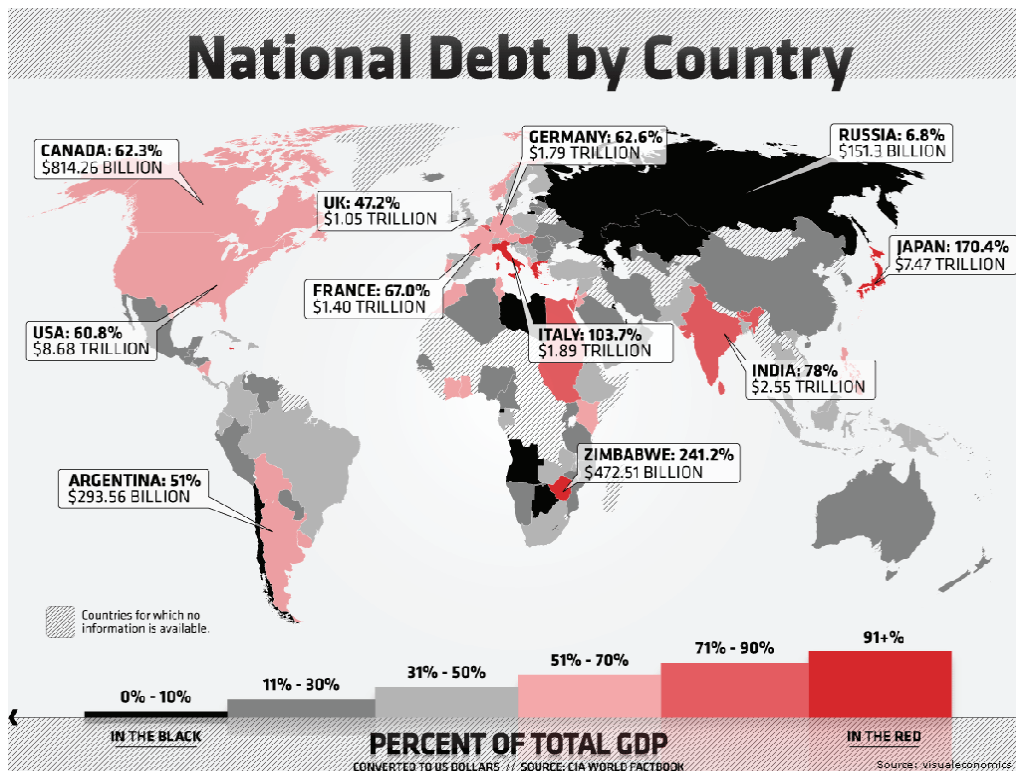
The Challenges

Since 2007, we have witnessed a series of financial shocks—at the household, firm and country levels—to which policy makers have reacted vigorously with the aim of restoring confidence to the global markets. Nevertheless, the recent Euro-zone turbulence indicates that this aim has not been achieved.



Policy makers and financial market participants are not agreed on whether fiscally vulnerable countries should be allowed an orderly debt restructuring, whether Euro rescue packages should make such restructuring superfluous, or whether new policy approaches could obviate the need for restructuring without requiring rescue packages.

What policy approaches are particularly promising? How can the gap between market expectations and government policy responses be bridged? This panel will explore these issues, with a view to providing proposals on how such currency-area problems can be fruitfully addressed in the future.





Proposed Solutions

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Tango lessons for Greece, Portugal and Spain

The Greek crisis has created fears of contagion in other countries of Europe, notably in Portugal and Spain. Unless it is resolved quickly and effectively, the spread will be more severe for it could affect other countries inside and outside of Europe. A growing consensus among international observers is that, despite a massive (€110bn) bailout package from the EU and the IMF in exchange for fiscal austerity measures, public debt restructuring in Greece will not be avoided.

We agree with this view. Back in 2001, when Argentina faced similar problems as Greece faces today, one of us had the misfortune to be at the helm of the finance ministry trying to do what, in retrospect, was an impossible task: to balance the fiscal accounts in the middle of a deep recession without restructuring an onerous public debt. Like Greece, Argentina had no easy resort to devaluation as a way to improve competitiveness since most of its liabilities, public and private, were denominated in hard currencies. Our first response came in the form of a series of measures designed to build up confidence and regain competitiveness, but they were not enough. Our second response came in the form of a fiscal consolidation plan that included a reduction in public wages and pensions. But, all this did was to deepen the recession and exacerbate social tensions. Only then it became clear that there was no alternative for us, but to restructure the public debt. If only we had acted earlier.

Ironically, as soon as an orderly and well-crafted restructuring plan was put in place, the IMF decided to suspend disbursements under the stand-by program, triggering a panic run on commercial banks and the peso, which resulted in financial collapse. The consequences are well known: More than 20 people died in street riots in December 2001, the president resigned, and a new interim government declared a default on the public debt and produced a massive devaluation, which resulted in stagflation: Real GDP fell by 11% and inflation increased from virtually zero to 41% a year in 2002. And, while it is true that the economy recovered strongly after that year, the reason was not the default or the devaluation, but the increase in commodity prices and the easing in credit conditions that accompanied the 2003–2007 global economic boom.

The main lessons for Greece stemming from Argentina are, in our opinion, as follows. First, devaluation (exiting the euro-zone) is not the answer, particularly since the post-crisis world outlook is unlikely to be as benign with Greece as it was with Argentina. Re-adopting the drachma and letting it fall in value relative to the euro would cause a sharp deterioration in the balance sheets of both the government and the private sector. On the other hand, a forcible conversion of euro-denominated financial assets and liabilities into drachmas (a replication of what Argentina did in 2002) would, in all likelihood, set in motion a perverse devaluation-inflation spiral, as people would want to substitute away from drachmas into Euros to avoid losing purchasing power if they stay in drachmas.

Second, any sovereign debt restructuring must be planned and executed in an orderly manner, with bilateral discussions between creditors and debtors, and with an active support from the international financial organizations, both in Europe and Washington DC (i.e., the IMF). These organizations can get more bang for their bucks if instead of trying to bailout



Greece's creditors over the next two years, they use their limited financial resources to enhance, a la Brady plan, new bonds that are swapped for the old ones in exchange for haircuts in principal, interest or both. A default followed by unilateral and incomplete debt restructuring several years later, as done by Argentina in the previous decade, would be the wrong model to follow.

Third, there must be fiscal consolidation. But, this can not be limited to cutting spending and raising taxes. It must also include fiscal measures designed to improve external competitiveness so as to ease the fiscal adjustment. Last but not least, the three ingredients of the recovery plan (fiscal consolidation, debt restructuring, and the enhancement of competitiveness) must take place simultaneously.

Improving external competitiveness through tax reform

In our opinion, Greece, Portugal, and Spain could achieve the same effect on competitiveness of a 20% real exchange rate devaluation by raising the collection of the value added tax (VAT) while simultaneously reducing payroll taxes. One characteristic of taxation in many countries—typically in Continental Europe, but also in Latin America and other regions—is that payroll taxes, which finance social security, are extremely high. Of course, this is due to the fact that social transfers are also very high. However, there is no reason why these transfers have to be financed by payroll taxes, especially if there is room to increase other, more neutral, taxes.

Take the VAT, for example. Unlike payroll taxes, which are levied on labor income, the VAT is levied on final consumption. This has two main advantages: It promotes formal job creation and it stimulates private saving. In countries like Greece, Portugal and Spain, this can kill three birds with one stone by helping to reduce unemployment, informality in the labor market, and the current account deficit. Furthermore, the fact that the VAT is levied on final consumption and not on investment or exports (capital goods purchases are deductible as VAT “credits” and exports are tax exempt) makes the substitution of VAT for payroll taxes a competitiveness-enhancing tool. As such, it is like devaluing the local currency, but without the inflationary pass-through to domestic prices or the disrupting balance sheet effects.

Another characteristic of taxation in the countries mentioned before is the disparity of VAT rates, including exemptions, across goods and services and regions of the same country. Such discrepancies are the cause of tax arbitrage and other inefficiencies in tax collection, which result in lower revenues for the government. While the objective of special rates and exemptions is to benefit or promote certain activities and areas of the country, including tourism, the same results could be obtained if a single rate was applied uniformly and the promoted activities and regions were subsidized directly from the budget.

Elsewhere, we have estimated that a unification of VAT rates could yield potential gains in tax collection of 9.6% of GDP in Greece, 8.1% in Portugal, and 7% in Spain. (In the case of Greece, our calculation was made when the general VAT rate was still 19%; now, that it was raised to 23%, the effect should be, obviously, higher). This would be enough to offset revenue losses resulting from the complete elimination of social security contributions paid by employers in all cases except Spain. The only reason why, in Spain, this would be the case is that the VAT rate (16%) is lower than in the other two countries. But, this could have been remedied by raising the Spanish VAT rate to a level closer to that of the other countries.

What would the effect on competitiveness be like? This can be easily estimated knowing the amount of payroll taxes contributed by employers and the statutory tax rates since the ratio between the two is the gross wage bill before payroll contributions. Dividing this by the wage bill inclusive of contributions yields the reduction in labor costs due to the elimination of said contributions. The results are 19% for Portugal, 22% for Greece, and 24% for Spain. The relevant question is: How much nominal devaluation would be needed in these countries, assuming they were to exit the Euro-zone, to achieve the same reduction in labor costs in terms of Euros that can be achieved through this measure? The answer, of course, depends



on the pass-through between devaluation and wage inflation likely to be observed in those countries. While this effect may be dampened by unemployment, it is unlikely to be low given the high degree of openness that characterizes the three economies. Assuming, conservatively, that the pass-through is 50%, the nominal devaluation required to lower wages by 20% in euro terms is 40%, enough to jeopardize the solvency of the entire corporate sector—including financial institutions, whose outstanding liabilities are denominated in euro and other hard currencies—not to mention the solvency of the public sector, where the debt exposure is even higher.

We do not ignore that a bold tax reform such as the one proposed here can make policy-makers wary. At issue is the fact that the three countries discussed here have high fiscal deficits and there is no guarantee that leveling the VAT rate will raise revenues proportionally to the effective tax increase. To address this issue, our proposal contemplates temporarily increasing the uniform VAT rate to 25% in Greece and Portugal and to 21% in Spain. Once again, since exports and capital formation are VAT-exempt, external competitiveness should not be affected.

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Provide ample liquidity assistance, but encourage restructuring of market debt if the country fails to regain market access

1. Need to establish regional monetary funds

In the absence of international liquidity support mechanisms, a “sudden stop” of capital flows can drive countries with fixed or quasi-pegged exchange rates and open capital accounts into sovereign default, regardless of whether their sovereign debt is sustainable or not. In order to avoid this, there is a need to establish permanent supranational institutions to provide temporary financial assistance to member states that have lost market access.

The IMF alone can not provide the necessary funding for countries that have lost market access, as it involves sums that far exceed its lending capacity. Therefore, the key missing element in the international financial architecture are regional monetary funds to co-finance IMF programs.

In order to mitigate financial risk to the international community and to minimize moral hazard, it is imperative that lending by these regional monetary funds enjoys seniority over market debt.

The establishment of a European Monetary Fund will change the constitutional setting of the European Union. Treaty change or at least “enhanced co-operation” will be required in order to provide this institution with sufficient legal validity.

2. Countries should be free to restructure sovereign debt if needed

If a sovereign fails to regain market access after several years of financial assistance and structural adjustment, then it should be clear to all parties that it is facing a solvency problem and not just a liquidity issue. In this case, the IMF and other multilateral lenders should encourage private sector involvement through debt restructuring, not least to safeguard the country’s capacity to repay its loans to multilateral lenders.

While there may be a case for a sovereign debt restructuring mechanism (SDRM) elsewhere in the world, the current legal and institutional framework already allows for an orderly restructuring of sovereign debt in Europe. The case for a SDRM rests mainly on the observation that in past restructuring exercises, holdout creditors have been able to enforce



claims against debtor countries in full, at the expense of consenting creditors. This free riding problem is due to the fact that most emerging markets sovereign debt has been issued under New York or English law. The bond prospectus often makes it impossible to make changes in the payment terms legally binding for all creditors, and it allows for litigation in US or UK courts. In the case of European countries, however, the great majority of bonded sovereign debt has been issued under domestic law (around 95% in the case of Greece), and these instruments can be restructured unilaterally. This greatly reduces collective action problems, and makes a SDRM largely redundant in Europe.