Europe’s New Regime with Sovereign Default

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Financing required July 2011-July 2012
(% GDP)

Not including sovereign guaranteed bank debt
Evolution towards the Sovereign Default Regime

• 2010 pre/post first Greek crises
  – “Default Unfathomable” J.C. Trichet
  – “No defaults on debt issued prior to July 2013” Merkel
  – “Greece has a sustainable debt burden” IMF

• Spring 2011
  – “Greece meeting nearly all performance criteria” IMF
  – “Imagine what would happen if an Asian investor woke up one morning and realized there had been a default on a European bond” Schaeuble

• Autumn 2011 – 40% or 60% write down?
Old Regime:
Sovereign Sacrosanct

New Regime:
Sovereign “defaults” when expedient
In essence, every European sovereign bond has a new clause:

• “In the event that the issuing sovereign cannot adequately finance itself in markets at reasonable interest rates, and if a sufficient plurality of the EU Council of Ministers/Eurogroup/ECB/IMF determine it is economically or politically expedient, then this bond will be restructured”

P.S. If the above clause is triggered then (i) the bond holder is junior to all official creditors if the official creditors so decide, and, (ii) the issuer reserves the right to change law as needed to negate any rights of the bond holder.
Ceteris Paribus, Italy needs an additional 6% GDP primary surplus to keep debt stable!
In a Highly Leveraged System, Small Changes can Cause Immediate Havoc
Banca D'Italia fights for independence, high real rates.
Status-quo (even after October 26) is not enough:

• The ECB/EU is playing chicken with the Greeks/Italians/Irish/Portuguese, just like the old (1980/90s) Banca D’Italia
• Risk premiums will stay high, causing credit contractions in troubled nations and disappointing growth
• Investors will use “2 trillion backstops” to sell out of bonds, so backstops can fail
• No amount of bank recapitalization will make investors comfortable with bank debt if sovereign risk remains large (French banks have 600bn euro exposure to Club-Med)
Three Broad Possible Paths

1. The ECB becomes the backstop in a much more committed manner
   - Troubled nations already dominate the ECB governing council and executive committee. Germany may not protest too hard.

2. Defaults, restructuring, spread through the euro area

3. Euro Area ends