Ernest Gnan
Head of the Economic Analysis Division
Oesterreichische Nationalbank

Introductory Remarks

Sovereign debt restructurings are, in a longer historical perspective, nothing extraordinary. Even countries currently viewed as examples of stability, such as Germany (as will be pointed out by Professor Ritschl in this volume), in the more distant past resorted to debt restructurings. While the process in the run up to these restructurings is usually messy and full of uncertainty, and thus is associated with financial system instability, once the restructuring decision has been made and the terms have been set (which in turn involves complex choices among many possible options and complex negotiations among many stakeholders), financial stability can often be restored. This is the result of improved fiscal sustainability, given the much lower remaining debt burden and the substantial structural and fiscal reform measures which usually form part of the conditionality associated with the debt restructuring package. In this sense, sovereign debt restructurings can stabilise financial systems in situations where the credibility of a sovereign debtor is already severely impaired and markets expect insolvency to happen.

Why are sovereign debt restructurings then such a taboo before they happen? The simple reason is that the expectation of debt restructuring itself increases a sovereign's risk premium, and thus, through higher financing costs, may increase the probability of a necessary debt restructuring. It is thus not in the interest of sovereign debtors to make restructurings a "standard feature" of creditor-debtor relationships. If they were fully priced in from the beginning, their benefit to governments would be lost. Obviously, fully rational bond markets and investors should not be subject to such cheating and should anticipate such time inconsistency problem of sovereign borrowers, but to the extent that markets are less than rational, e.g. due to "short memory" and "myopia", "herd behaviour" and "benchmarking" etc., it might still pay for sovereign borrowers to deny the possibility of bankruptcy as long as possible. Therefore, the idea of establishing sovereign restructuring procedures ex ante goes against the very nature of the sovereign creditor-debtor "game", as it happens in the real world.

In EMU, matters are often perceived to be complicated by several factors. First, setting a precedence of debt restructuring with one country can have contagion effects on other euro area countries. This was one of the more often used arguments against "private sector involvement". If restructuring expectations are non-rational and are influenced by recent experiences in nearby countries, then this might indeed be the case. However, it is

not fully clear why such effect should be specific to countries forming part of a monetary union. Such expectational contagion effects can happen between any countries regarded by markets as similar in nature and/or linked through various real and financial channels. Only to the extent that EMU is associated with – actual or perceived – closer real and financial linkages, will contagion become an issues specific to EMU.

Second, it is sometimes argued that an individual euro area country does not have the ultimate resort of monetary financing and/or nominal exchange rate devaluation to reduce its debt burden and restore international price competitiveness and economic growth. Thus, the argument goes, debt restructuring in EMU might be more difficult to avoid. However, to the extent that a sufficiently large group of EMU countries is in distress or fears possible contagion or other negative repercussions from a debt crisis, the ECB is likely to behave in ways similar to a central bank of an individual country. The ECB's Securities Market Program and Outright Monetary Transactions, while motivated by monetary policy considerations (restoring monetary policy transmission), in effect absorb government debt of distressed countries and thus facilitate government financing.

Furthermore, the various intra-euro area financial support programmes (European Financial Stability Facility, European Stability Mechanism etc.) provide help which would not normally be available for individual countries outside EMU. This would even make the need to resort to sovereign debt restructuring less urgent in EMU than outside.

The question is how far this mutual support within EMU – be it through governmental aid, be it through central bank intervention – should optimally go. To illustrate the different positions currently debated on this matter, let me sketch two extreme, stylised and simplified views: On the one hand, those emphasising contagion and systemic risk from sovereign debt crises and ultimately bankruptcies would argue for more such support, whatever its concrete form and source. If only support mechanisms are sufficiently large, speculation against the problem countries will be deterred and the crisis will soon be over, the argument goes. On the other hand, those who emphasise that the very existence of support mechanisms alters recipient countries' incentives to embark on necessary structural reforms and fiscal consolidations would argue against aid, and would rather have problem countries face bankruptcy or even exit from EMU. In their view, the serious threat of bankruptcy and euro area expulsion would activate the necessary reform efforts to solve the crisis and render further assistance unnecessary. While these two extreme views obviously are grossly simplified caricatures of the much more complex problems and lines of argument at hand, it is nevertheless interesting to recognize that both views rest on a strong role of expectations and incentives. In a way, they are different scenarios of the same "game", emphasising expectations and incentives of, in the first case, financial markets, and, in the second case, governments or societies in debtor countries.

With respect to the theme of this session, the former group of analysts would argue that, in order to contain systemic risk, immediate and decisive stepping up mutual support mechanisms is unavoidable. Various forms of

Eurobonds, such as the scheme which Jakob von Weizsäcker explains in this volume, are part of such extended support mechanisms.

The latter group of analysts would argue that by providing such support mechanisms, any remaining mechanisms for fiscal discipline will be wiped out, leading, over the medium to long run, to more instability in public finances and ultimately to the value of the currency. Furthermore, it is argued by this group that the expansionary policies potentially lead to new macroeconomic imbalances, such as asset price bubbles in the safe-haven creditor countries. All this might, in their view, in the long run pose risks to systemic financial stability.

So, in addition to differences in focus between market versus government failure, there are also differences in time horizons which may explain, among other things, the differences in various experts' views and recommendations.

I am sure, though that the crude toolkit I just offered can do no justice to the presentations by our two speakers of this session, Albrecht Ritschl, Professor at the London School of Economics, and Jakob von Weizsäcker, Head of Department at the Thuringian Economics Ministry. As always, reality and human thinking to explain it are much more complex than simple stylised models or "boxes" of schools of thought.