The Realpolitik of Sovereign Debt Restructuring: Monetary and Fiscal Observations from the Front Line

Alfonso Prat-Gay

The Philadelphia Fed Policy Forum

Budgets on the Brink: Perspectives on Debt and Monetary Policy

Friday, December 2, 2011
ALL DEBT CRISES ARE CREATED EQUAL
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Ireland - 2008

- Change PC/GDP: 105%
- CA Deficit/GDP: 6.5%
- Pub Debt/GDP: 25%
- Fiscal Deficit/GDP: -0.1%
ALL DEBT CRISSES ARE CREATED EQUAL
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Italy - 2010

- Change PC/GDP: 44%
- CA Deficit/GDP: 3.5%
- Pub Debt/GDP: 118%
- Fiscal Deficit/GDP: 4.6%
ALL DEBT CRISES ARE CREATED EQUAL

Spain - 2010

Change PC/GDP: 43%
CA Deficit/GDP: 4.6%
Pub Debt/GDP: 61%
Fiscal Deficit/GDP: 9.3%
ALL DEBT CRISSES ARE CREATED EQUAL

Portugal - 2010

Change PC/GDP: 37%
CA Deficit/GDP: 9.8%
Pub Debt/GDP: 93%
Fiscal Deficit/GDP: 9.8%
ALL DEBT CRISIS ARE CREATED EQUAL

Iceland - 2008

- Change PC/GDP: 135%
- CA Deficit/GDP: 25%
- Pub Debt/GDP: 93%
- Fiscal Deficit/GDP: 10.1%
ALL DEBT CRISES ARE CREATED EQUAL

Greece - 2009

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change PC/GDP</td>
<td>139%</td>
</tr>
<tr>
<td>CA Deficit/GDP</td>
<td>11.1%</td>
</tr>
<tr>
<td>Pub Debt/GDP</td>
<td>129%</td>
</tr>
<tr>
<td>Fiscal Deficit/GDP</td>
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</table>
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MORE OFTEN THAN NOT LEVERAGE IS THE MAIN “INNOVATION”
“GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH”

THE SEQUENCING OF CRISES
“GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH”

THE SEQUENCING OF CRISES

1. Financial liberalization
2. Economic boom + market bubble
3. Stock and real estate market crashes
4. Economic slowdown
5. Banking crisis
“GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH”

THE SEQUENCING OF CRISES

Financial liberalization → Economic boom + market bubble → Stock and real estate market crashes → Economic slowdown → Banking crisis

US and EU now
“GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH”

THE SEQUENCING OF CRISES

US and EU now

- Financial liberalization
- Economic boom + market bubble
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- Banking crisis
- Currency crisis
- Inflation pick up

IF FX PEG
“GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH”

THE SEQUENCING OF CRISES

- Financial liberalization
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External and/or debt default

- Currency crisis
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US and EU now

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US and EU now

- Financial liberalization
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Greece? (and others)

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SOMETHING TO BEAR IN MIND WHEN TRYING TO AVOID THE NEXT CRISIS
# STYLIZED LOSSES: US & EU ARE PROBABLY HALF-WAY THROUGH

<table>
<thead>
<tr>
<th>Crisis Country</th>
<th>Year</th>
<th>Deposits (1)</th>
<th>NW (2)</th>
<th>Fiscal Bailout (%GDP)</th>
<th>Outside Money (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>94-95</td>
<td>-15%</td>
<td>-64%</td>
<td>19,3%</td>
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<tr>
<td>Venezuela</td>
<td>94-95</td>
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<td>-1,0%</td>
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<tr>
<td>Ecuador</td>
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<tr>
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<tr>
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<tr>
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(1) Peak to trough
(2) Net Worth Change, two years after the crisis
(3) IMF + Germany (TARGET2 + EFSF)
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CUPBOARDS ARE STILL CROWDED WITH CORPSES

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<tr>
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<td>($ trillion)</td>
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<tr>
<td>Government funds allocated to financial system (1)</td>
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<td>of which, central banks' rediscouts or swaps</td>
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<tr>
<td>Undisclosed Losses (2)</td>
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<td>European sovereign debt</td>
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<td>Mortgages</td>
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<tr>
<td>Consumer credit</td>
<td>0.17</td>
<td>0.14</td>
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<tr>
<td>Others (derivatives, SIV, CDO, etc.)</td>
<td>0.56</td>
<td>1.13</td>
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<tr>
<td>Final Bill: (1) + (2)</td>
<td>4.6</td>
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DON´T ALWAYS TRUST STRESS TESTS
A REPRESENTATIVE AGENT’S STRESS TEST RESULTS:
ARGENTINA, CIRCA END 2002
LIFE IS NOT ALWAYS NECESSARILY FAIR

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• Poverty rate @ 57%
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- Banking crisis:
  - Non performing loans @ 37%
  - Rediscounts @ 105% of NW and 37% of deposits
  - Credit to private sector @ 30% of peak (i.e. down 70%)
  - Balance sheets
  - ROE @ -50%

"Pesified" claims (lawsuits @ 20% of bank deposits)

All financial markets fully shut down (∞ counterparty risk)
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FISCAL, FINANCIAL, PROVINCIAL AND JUDICIARY DOMINANCE
“ALL YOU NEED IS GROWTH, GROWTH IS ALL YOU NEED”

FOR BOTH SOVEREIGNS AND BANKS ALIKE

<table>
<thead>
<tr>
<th>Some things we did then</th>
<th>Now useful for</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sovereign Risk</strong></td>
<td></td>
</tr>
<tr>
<td>1. Exposure</td>
<td>Dic-02</td>
</tr>
<tr>
<td></td>
<td>52%</td>
</tr>
<tr>
<td></td>
<td>Regulatory target</td>
</tr>
<tr>
<td></td>
<td>40% by Jan-06</td>
</tr>
<tr>
<td></td>
<td>Reached</td>
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<tr>
<td></td>
<td>Sep-04</td>
</tr>
<tr>
<td>2. Valuation</td>
<td>Investment book</td>
</tr>
<tr>
<td></td>
<td>Rising benchmark YTM and mark to market by Jun-08</td>
</tr>
<tr>
<td></td>
<td>Juni-05</td>
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<td><strong>Solvency</strong></td>
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<tr>
<td>1. Rising CARS</td>
<td>Dic-02</td>
</tr>
<tr>
<td></td>
<td>3.50%</td>
</tr>
<tr>
<td></td>
<td>Regulatory target</td>
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<td></td>
<td>8% by 2008</td>
</tr>
<tr>
<td></td>
<td>Reached</td>
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<tr>
<td></td>
<td>2006</td>
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<tr>
<td>2. Reprogramming rediscouts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>70 months @ matching rate</td>
</tr>
<tr>
<td></td>
<td>Cancellation before schedule in all cases</td>
</tr>
<tr>
<td>3. 3-year business plans</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Extended from troubled banks to all banks</td>
</tr>
<tr>
<td>4. USD loans to non exporters banned</td>
<td>Monitored quartery</td>
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<td><strong>Liquidity</strong></td>
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<tr>
<td>1. Deposit unfreeze</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Thanks to 2. above</td>
</tr>
<tr>
<td></td>
<td>Sep-04: 97% of frozen deposits</td>
</tr>
<tr>
<td>2. Counterparty Risk</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Use CB clearing house for settlement of FX operations</td>
</tr>
<tr>
<td></td>
<td>TED and OIS-Libor spreads</td>
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1. Know the size of the bill
2. Find out how deep is your wallet
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3. Draw the line (somewhere)
4. Plan (way) ahead the next move
5. Whenever possible, be ahead of the market
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THE OLD RULES (AND BALANCE OF POWER) NO LONGER APPLY
A HUNDRED YEARS AGO…

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_The Economic Consequences of the Peace_ (1919)
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