IPC-Residence Palace
155 rue de la Loi
B-1040 Brussels, Belgium
Tel.: +32 (0)2 647 95 75
Fax: +32 (0)2 640 98 28
e-mail: info@lisboncouncil.net

Press Release

Contact: Paul Hofheinz
Phone: +32 (0)475 272 373

EMBARGOED
08H00 CET 03 MAY 2011

NEW POLICY BRIEF

THINKING THE UNTHINKABLE
LESSONS OF PAST SOVEREIGN DEBT RESTRUCTURINGS

By Alessandro Leipold

European debt resolution requires a much more forward-leaning, information-driven approach

Policy makers should supply markets with better, more timely information (including tougher banking stress tests), abandon untenable timelines and stay ahead of the game via recourse to tools such as pre-emptive bond exchange offers

(BRUSSELS, Belgium, 03 May 2011) – Today, the Lisbon Council launches **Thinking the Unthinkable: Lessons of Past Sovereign Debt Restructurings**, a new e-brief by **Alessandro Leipold**, chief economist of the Lisbon Council and former acting director of the European Department at the International Monetary Fund (IMF).

The e-brief can be downloaded on the Lisbon Council website at www.lisboncouncil.net.

Drawing on his decades of experience at the centre of financial crisis prevention and management, Mr. Leipold argues that European debt resolution requires a much more forward-leaning, information-driven approach, involving supplying markets with better, more timely information (including tougher banking stress tests), abandoning untenable timelines (such as the “no-restructurings-before-2013” mantra), and staying ahead of the game via recourse to tools such as pre-emptive bond exchange offers, which were successfully deployed by Pakistan, Ukraine, Uruguay and the Dominican Republic in the last bout of severe debt crises of the early 2000s.

The five main recommendations are:

1. **Avoid Detrimental Delays.** Delays in needed restructuring are costly: they stand to increase output losses, entail “throwing good money after bad” via increasingly large official bailouts, and ultimately require a larger haircut on private claims. Realistic debt sustainability analyses are needed on a timely basis to readily detect, and communicate to the authorities, the possible need for debt restructuring. Once ascertained, action should follow promptly. The EU’s “read-my-lips: no-restructuring-until-2013” sets an arbitrary and non-credible deadline: the sooner it is abandoned, the better.

2. **Repair the Banking Sector**. The equation “euro debt crisis equals core European bank crisis” needs to be broken. This requires getting tough on bank stress tests, enhancing their rigour and credibility, possibly by associating the Bank of International Settlements (BIS) and IMF with European Union supervisors. A key credibility failing of EU bank stress tests has been the absence of a sovereign debt default assumption in the scenarios. When the most evident and, in the markets’ view most likely, “stressor” is not included even as a hypothesis in the sensitivity scenarios, the value of the tests is clearly questionable. Stress tests must be accompanied by much greater pressure from EU supervisors to speed up bank recapitalisation and by action, where needed, to close down non-viable entities. Banking resolution legislation should proceed rapidly, as should creation of an EU-wide bank resolution mechanism.

3. **Remove Politics from the Driver’s Seat.** Realistically, political considerations will always be present in any sovereign debt restructuring. But the current set-up (and the set-up envisaged for the European Stability Mechanism (ESM), which will begin operations in 2013) virtually ensures that EU creditor countries’ domestic political interests will play a front-and-centre role. The recent attempted *quid pro quo* with Ireland whereby Europe would agree to a reduction in the crippingly high interest rate on its loans in return for changes to the Irish corporate tax code is but one indication of this. Put simply, the decision-making and governance mechanism should be distanced from the high-pitched political positioning characteristic of EU ministerial meetings, thereby also facilitating

constructive communication with markets, and helping shape expectations as needed to promote crisis resolution.

4. **Stay Ahead of the Curve with Pre-emptive Exchange Offers.** Traditional bond exchange offers, made pre-emptively, prior to an actual default, worked well in several emerging country debt restructurings over the last decade or so, including Pakistan, Ukraine, Uruguay and the Dominican Republic. Experience indicates that such voluntary restructurings need not, contrary to some claims, be too "soft" for the debtors' needs. Reasonably priced, and with proper incentives, deals can be concluded rapidly with negligible free riding.

5. **Do Not Expect Too Much from Collective Action Clauses.** Contractual provisions such as collective action and aggregation clauses no doubt help at the margin. But they have not shown themselves to be decisive in debt restructurings. Furthermore, they cannot help in dealing with the current stock of debt.

About Alessandro Leipold: Alessandro Leipold is **chief economist of the Lisbon Council.** Born in Italy, Mr. Leipold has had a distinguished career in international economics and finance, banking, the European Union organisations and the International Monetary Fund (IMF), where he was acting director of the European Department until the end of 2008. After receiving an advanced degree in economics from Bocconi University, Mr. Leipold's career began as an economist in the research department of Credito Italiano in Milan. Subsequently at the European Commission in Brussels, as a member of the secretariat of the Monetary Committee (now the Economic and Financial Committee), Mr. Leipold was closely involved in the work setting up the European Monetary System (EMS) in 1978-79, participated in the series of EMS realignments of the early 1980s, and worked on European structural and financial integration issues. He joined the IMF in 1982, where his career spanned surveillance and programme work, leadership of the IMF's international capital markets missions, and IMF governance issues. From 1998, he was part of the senior management team of the European Department at the IMF, with responsibilities covering regional studies, oversight of World Economic Outlook forecasts for Europe, and leadership of IMF missions to several major European countries, including France, Italy, and Spain. In 2008, he led the IMF's mission to the euro area, with presentations to the Eurogroup of finance ministers, and filled the position of acting director of the European Department,

leading its activities during the financial crisis and the Fund's programmes in Hungary, Ukraine, Latvia and Iceland. He has given numerous presentations on international financial issues, lately centred on the global crisis and challenges and opportunities going forward. *Thinking the Unthinkable: Lessons of Past Sovereign Debt Restructurings* is his third paper on the European debt crisis for the Lisbon Council. Other Lisbon Council papers can be downloaded on the Lisbon Council website at www.lisboncouncil.net.

About the Lisbon Council: The Lisbon Council for Economic Competitiveness and Social Renewal asbl is a Brussels-based think tank and policy network. Established in 2003 in Belgium as a non-profit, non-partisan association, the group is dedicated to making a positive contribution through cutting-edge research and by engaging politicians and the public at large in a constructive exchange about Europe's economic and social future. Its website is www.lisboncouncil.net.

For press queries and additional information, please contact

Paul Hofheinz
The Lisbon Council
paul.hofheinz@lisboncouncil.net
+32 (0)495 272 373

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