Portugal Ought Not Restructure Its Debt

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SUMMARY

At the epicenter of the international financial crisis is a debt crisis where low-quality assets and the slowdown in economic activity have made creditors worldwide wary of the ability and willingness of debtors to comply with their obligations. In this context of indebtedness, now perceived as excessive, where expenses on interest are growing, some defend debt restructuring to alleviate this burden. This brief note aims to contribute towards the current debate with an analysis of the benefits and costs related to the possible but uncertain unilateral decision by Portugal to alleviate its expenses on interest. Considering i) the most recent international evidence that suggests that in the majority of the cases a debt restructuring is accompanied by a banking crisis and/or by a currency crisis, ii) that Portugal does not meet any of the cost-minimizing criteria, and iii) that an exit from the euro would probably be inevitable as a result of such a decision, we conclude that Portugal ought not restructure its debt.

Keywords: Debt crisis; International financial crisis; Restructuring; Troika.

1. INTRODUCTION

Imagine for an instant that the Executive is pondering a restructuring of the Portuguese debt. The question that immediately follows is “What implications would such a decision have?”. It would have a few benefits and a few costs that are worth analyzing. Nonetheless, the historically backed-up fact that a sovereign State only goes ahead with a restructuring of its debt when it has no other available options suggests that, probably, total costs outweigh total benefits.

Those who see a restructuring of debt as an alternative to austerity are clearly mistaken. In this article we present a few reasons why, with a restructuring of debt, the adjustment of the Portuguese economy would probably be more brutal than what is happening at present. Likewise, a restructuring does not guarantee a sustainable trajectory for the dynamics of debt (International Monetary Fund, 2006).

Before detailing the costs and benefits inherent to a restructuring, it is worth trying to understand what restructuring of debt is. In simple terms, it consists in altering the form of existing debt with the objective of alleviating interest expenses. Such an alteration could be attained i) by reducing the nominal or face value of the debt (this would be classified as a “haircut” if the reduction were less than 100% and would be classified as a “default” in case of a complete reduction), or ii) by lowering the implicit interest rates, or iii) by lengthening the maturity of the loans.

The remainder of this note is as follows: Section 2 presents the benefits inherent to a restructuring of debt in Portugal, while Section 3 is dedicated to listing the respective costs and detailing the dynamic effects that would follow, as a series of negative shocks would propagate through the economy. Section 4 concludes with an indication of a set of criteria that allow an economy in those circumstances to reduce the costs related to the decision of restructuring its debt. For the record, Portugal does not fulfill any of the said criteria.

2. BENEFITS RELATED TO RESTRUCTURING

If, even with a restructuring of debt, one cannot escape austerity nor can one guarantee the sustainability of one's debt, what then is the benefit? To be able to redirect a part or all of the previous expense on interest to jumpstarting economic activity in Portugal. If private consumption were the main beneficiary then that jumpstart would be temporary at best. To be more long-lasting, one would have to focus on the factors behind economic growth, probably using the amount saved by not paying (that much on) interest to facilitate the most important structural reforms.

3. COSTS RELATED TO RESTRUCTURING

According to the IMF (see International Monetary Fund, 2003) every episode of debt restructuring is different. It is always a leap into the unknown because there is no pattern or script as to how a debt crisis unfolds. Having said that, we have to examine the empirical evidence and see what it suggests.

There are naturally many studies on the impact of a debt crisis on GDP (for a discussion of the existing literature see, for example, International Monetary Fund, 2002 or, the more encyclopedic Roubini and Setser, 2004). In this note, however we choose to reference a more recent article by the Bank of England (De Paoli, Hoggarth e Sapporta, 2009) that bypasses the well-known econometric problem of endogeneity, due to a joint causality between the dependent variable and some of the explanatory variables. This research adopts a significantly more sophisticated methodology compared to the previous effort by the same authors (De Paoli, Hoggarth e Sapporta, 2006). Analyzing 32 episodes in emerging economies that occurred between 1970 and 2000, they conclude that most frequently (in 53% of the cases observed) debt crises rarely occurred in isolation; they are typically accompanied by banking crises and/or by currency crises, something that raises the median duration of the crisis from 4 to 14 years and that accentuates the annual fall in GDP from 2.5% to 11.1%. For Portugal, restructuring its debt would very likely entail having to abandon the euro, something that would make the occurrence of a triple crisis even more probable. It is in this analytical setting that this note presents and details the costs related to a restructuring of debt.

In the Portuguese case, an immediate implication of restructuring its debt would be to stop receiving the outstanding *tranches* of the €78 billion loaned to us (International Monetary Fund, 2011). Without short-term financing, Portugal would face the same cash-flow problems it encountered in mid 2011 that led to the bailout agreement.

Would Portugal then be excluded from the international capital markets? Possibly yes in the very-short term, but that would not last more than one year (a situation that would already be very problematic in terms of cash-flow management). The more important question, however, is under what conditions would Portugal have access to financing? Reflecting a higher country-specific risk, financing costs would be permanently higher than if the restructuring episode had never happened. Historical evidence (see, for example, International Monetary Fund, 2006) suggests that, even for those countries that, having restructured their debt, then went on to correct their excessive indebtedness, the market tends to permanently attribute a worse credit rating and a more elevated spread. If, a couple of years later, there are few opportunities at a global level to earn a reasonable real return, then we can expect foreign investors (seeking out higher yields) to return to the country that was once pariah.

And could Portugal suffer other penalties by foreign creditors, for example in the form of trade sanctions? It's possible but unlikely, given that the creditors that provide trade credit are typically not the same ones that suffer losses from restructured debt. In any case, one could expect a few short-term disturbances that would delay the delivery of medication and energy, for example.

In addition to foreign creditors, some domestic economic agents would also suffer losses from restructured debt. That would be the case of financial intermediaries such as banks and pension funds and also of a few firms. The situation would be all the more serious for the balance sheet of these entities if the immediate liquidity needs were such that they could not wait for the price of the Treasuries to recover. A weakened balance sheet would thus imply greater difficulties for banks to grant credit to the economy and also for firms to finance an expansion of their activity.

Unfortunately, the bad news for the Portuguese economy would not stop there. As will soon become clear in what follows, a debt restructuring episode can be the trigger of a more generalized financial crisis accompanied by a strong reduction in economic activity. In that case, the strategy aimed at redirecting the interest expense towards jumpstarting the economy may not reach the intended objective if economic agents lose their access to financing from domestic and foreign creditors.

But, if Portugal stops paying interest on its debt, is fiscal austerity no longer necessary? A short-lived break would be achieved that would allow us some breathing space for a few months, if that much. The problem would come later on. Without the same access to capital markets, it would quickly become evident that nobody would finance the budget deficit. At that moment in time, total public spending would have to be ratcheted down to total public revenues, that would not only be below trend, they would also be falling sharply given a narrowing of the tax bases as a result of teetering economic activity. Portugal would then feel a fiscal squeeze on the spending side like it has never felt before, with even more significant cuts to civil servants' wages, pensioners' entitlements and all other remaining spending items.

If a regime of financial repression were in place whereby banks would be obligated to buy public debt securities, then the quality of the assets held on their balance sheets would further deteriorate, thus implying a new contraction to the credit granted to all economic agents. If such a situation were to persist for some time, banks would have to be recapitalized, either with huge costs for the Treasury, leading to a new round of fiscal austerity, or otherwise with help from the central bank, if Portugal were to already have an independent monetary policy. This alternative would result in unexpected inflation that would probably lead to a generalized crisis of confidence, of which a sustained currency depreciation would be a nasty symptom. Portugal would thus enter into an even more dangerous phase for its economy. The breach of confidence in the Portuguese State by economic agents (first foreign and then domestic ones) would be the starting point of a deep, general and long-lasting financial crisis.

If, as a result of debt restructuring, domestic economic agents were to question the capacity and commitment of the Portuguese State in honoring its domestic obligations, then a bank run could occur, given the frailty of the banking sector at that time. In such a case, not even an insurance mechanism that guarantees deposits would be of much help.

After a decapitalization of the banks, capital would further flee from the debtor country, not only by foreigners but also by domestic economic agents. With the objective of wealth preservation in real terms, everyone would enact a strategy of substituting domestic currency denominated assets for those denominated in foreign currency. With a domestic currency other than the euro, Portugal would quickly lose the foreign exchange reserves it currently has, thus precipitating a brutal domestic currency depreciation.

For those who think that a depreciation of the domestic currency would be advantageous in the sense that it would help boost exports through a (temporary) gain in cost competitiveness would do well to remember the vicious cycle of competitive devaluations we experienced in Portugal in the 80s/90s (see, for exemple, Abreu, 2001). First, a currency depreciation would make imports more expensive when measured in the domestic currency, thus raising the cost of living and feeding a spiral of ever-increasing expected inflation. Second, the gains in terms of cost-competitiveness (measured, for example, using the real exchange rate) were always temporary, because they disappeared with an inflation in Portugal that was always higher than that of our competitors. Third, a currency depreciation increased the domestic value of the debts denominated in foreign currency, thus further degrading the balance sheets of the banks and firms that had obtained loans from foreigners. In a context of inflation that is out of control, sooner or later a contractionary monetary policy would follow with the objective of slowing the loss in value of the domestic currency, but that would inevitably induce a liquidity squeeze and a new restriction on credit to the economy. In this context, in the short term, it would be close to impossible to find reasons to justify a quick economic recovery.

4. CONCLUDING REMARKS

The reader that has made it this far without having skipped Section 3 must surely be thinking: on one hand, it’s possible that if Portugal unilaterally restructures its debt to lower its interest expense then a catastrophic outcome will occur; on the other hand, she wonders how likely such a tragic scenario is and whether in the recent past there were at least a few debt restructuring episodes that were successful.

Obviously not all debt restructuring episodes that ever occurred turned out to be disastrous. In that sense, in an attempt to convince the reader that not only would such a tragic outcome in Portugal be possible but also highly likely, it is worth listing a set of circumstances under which the costs related to a restructuring of debt would be less significant, thus adding some light to a very somber macroeconomic outlook.

In Section 3 we presented the labyrinth of channels through which a restructuring of debt by a sovereign can propagate through the economy, leading to a series of obstacles to a jumpstart of economic activity. These very negative dynamic effects that are also self-reinforcing until a regime change is prompted can obviously be toned down in certain cases.

The costs related to a restructuring of debt will be minimized in an economy characterized by the following:

a) Firms finance themselves mostly through equity and not through debt;
b) The banking sector is not characterized by a regime of financial repression (i.e. the banks are not obligated to buy Treasuries);
c) Foreign indebtedness is relatively low;
d) The country is not very dependent on trade, in terms of having to import raw materials and energy, for example; and
e) The central bank has ample foreign exchange reserves.

Criteria a) allows the economy to soften the fall in GDP that results from a restricted supply of credit by the banks. Criteria b) short-circuits the vicious cycle between the loss of value of Treasuries that results from higher risk premia and the financial health of the banks themselves that, when it takes a turn for the worse, can require a bank recapitalization with severe fiscal costs, thus confirming the initial suspicion by financial markets. Criteria c) ensures that a currency depreciation or devaluation does not increase the value of the banks' and firms' liabilities when these liabilities are measured in terms of the domestic currency. Criteria d) ensures that trade sanctions are mostly ineffective. And finally, criteria e) guarantees that the central bank has the firepower to defend itself from a currency attack.

Unfortunately, Portugal does not fit any of these criteria, and thus we are led to conclude that it ought not restructure its debt.

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