

WHY RESTRUCTURING OF THE ITALIAN PUBLIC DEBT SHOULD BE AVOIDED

By *Giampaolo Galli*

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I would like to answer a question that was put forward very clearly by Jeronim Zettelmeyer, a highly respected German economist, now at the Peterson Institute in Washington DC. He asked:

Why there is much skepticism among Italian economists about the “Franco-German” idea of making debt restructuring a more feasible option of the euro architecture?

I will do my best to answer this question, although I should make clear that here I am expressing my own personal opinions and do not claim to represent the economics profession in Italy.

Before presenting the analytical arguments, let me say that:

- a. Defaults and restructuring can happen. They are a fact of life, whether or not they are a rational choice. One cannot conceive a federation of states in which some states provide an unlimited guarantee to other states.
- b. I believe that market discipline usually works better than EU budgetary rules. Moreover, I sympathize with the idea of making markets do the work in a better and more effective way. Far too often, we see markets reacting too slowly and too abruptly, a point that was made in the Delors Report and that is the logical underpinning of the system of fiscal rules that we have in the EU.¹ This means that governments live under the illusion that they can pile up mountains of debts and keep refinancing it at low rates. Moreover, the realization that such strategy will not work perpetually does not arrive in the minds of the government officials and politicians until it is too late.
- c. I realize that sovereign restructuring may be unavoidable and perhaps appropriate under some circumstances, which are mainly the following:
 - i) A country asks for external assistance, which means money of foreign taxpayers;
 - ii) The restructuring is part of a package agreed with official creditors aimed at fiscal rectitude and is by no means a substitute for fiscal rectitude;
 - iii) The restructuring is not too large in a sense that I will try to make clear.

Having said the foregoing, one should be clear about the ultimate goal of what we are doing, that is convincing Italy to implement a credible plan to improve its budget, according to the European rules. The goal cannot be the restructuring of public debt: a restructuring in the absence of a credible fiscal plan would be a tremendous problem for Italy and cause harm to the rest of the Eurozone as well. Therefore, I am objecting to the idea that restructuring is a way to “solve the

¹ See Committeri and Tommasini (2018).

problem of the debt”, i.e. that it is an alternative to fiscal rectitude. Restructuring can at best be a complement to fiscal rectitude, unless it is a necessity. Then, however, we are not talking about rational choices, but about disaster management at best. I will explain why below.

- a) The critical thing to have in mind is that restructuring the Italian debt is a different story from what various emerging economies dealt with by the IMF in recent decades and also from Greece. The reason is that in these cases, most of the debt was held by foreign banks or by a small number of wealthy nationals who held domestic bonds through illegal foreign deposits. In these cases, restructuring imposed a burden on foreign institutions and a few wealthy nationals. In the case of Italy, it would impose a substantial burden on domestic residents who hold public debt either directly or through (mutual or pension) funds. Residents hold about 70% of public debt in Italy today, while they held roughly 30% in Greece in 2012. ² This is an essential difference from a social and political point of view.
- b) There are also different economic consequences, because, when public debt is large and widely held by the population, a restructuring of the debt will be detrimental to domestic demand, through three main channels:
 - (i) Wealth effects on consumption, because restructuring is a tax on wealth;
 - (ii) Reputational effects that may prevent private companies to access markets for quite some time given that corporate ratings are linked to sovereign ratings and both would be at junk level;
 - (iii) A credit crunch, since bank capital would be eroded by the loss on government bonds. The importance of this argument depends on how large the restructuring is. Here, I come to the critical analytical argument.
- c) A small restructuring will cause the markets to expect a bigger one, and capital flight will be huge (unless accompanied by a significant shift in budgetary policy to make the debt sustainable in the context of an agreement with official creditors).
- d) In turn, this means that the restructuring makes sense only if it is large, in the sense that it is a definitive and credible solution to the problem of the debt. This means that a debt of 130% of GDP must be cut down to something like 80 or 90 per cent. This move is bound to cause a major recession, through the three channels mentioned above. In addition, the restructuring (which should involve a strong re-profiling) would have to be accompanied by very tight budgetary policy both to minimize the need to tap the markets the next day and to regain credibility. These actions would aggravate the fall in domestic demand. ESM and IMF resources can smooth the transition and allow a country to continue running a small

² 17.3% of the total debt (euro 2,317 billion, including a small portion of loans) is held by the Bank of Italy, 28.2 by Italian banks, 19.6 by Italian non-bank financial institutions, 5.3% by other Italian residents, and 29.5 by non-residents. Bank of Italy, The public finances: borrowing requirement and debt, March 15, 2019 (data as of Dec. 31, 2018).

deficit for some time, but at the end of the transition, after 3 or 4 years, the country must be able to regain access to the markets, which in any case requires that the budget be brought in equilibrium (which essentially means balanced budget). In the end, fiscal rectitude is necessary, whether or not there is a restructuring, but it is more difficult to exercise if there is a restructuring because the latter damages domestic demand and does not do much to reduce the primary surplus that is needed to put the debt on a downward path.³

- e) To these considerations, one should add that a large part of the debt (like in the case of Greece) is held by domestic banks, which following a restructuring would need to be recapitalized, otherwise one would not only have a credit crunch, but a full-fledged banking crisis. This means that the state would have to ask for official loans, implying that on this part of the debt there would be little or no relief.

SOME TENTATIVE CONCLUSIONS

Given these considerations, I propose the following tentative conclusions:

- a) A small restructuring is likely to aggravate a fiscal crisis because agents will come to expect a more extensive restructuring. (This will not occur only if the restructuring is part of a credible package to make the debt sustainable through a higher primary surplus).
- b) A large restructuring, on the other hand, bringing the debt down from – say – 130% to 80%, will cause serious damage to domestic demand, thus making it more difficult to put the debt ratio on a sustainable path. Such negative effects could last for several years because of the loss of reputation in the markets.
- c) At the end of the story, the budget must be balanced and the level of the debt makes a relatively small difference in the primary surplus that is needed. Hence, the path to fiscal rectitude is far less painful without restructuring because restructuring reduces the debt, but causes significant damage to domestic demand. It is obvious, but it is worth repeating, that if the government never undertakes fiscal responsibility, then default and restructuring became a necessity, but – I should add – a dramatic necessity.
- d) I doubt that there can be such thing as an orderly restructuring when the debt is large and is held by millions of domestic savers. Major financial disruptions are to be expected as well as social and political tensions of great magnitude. The experience of Argentina in 2000-2001 probably gives one a sense of how bad

³ If $(r-g)$ is around zero, the level of the debt ratio is irrelevant for debt dynamics. If it is +1%, then having an initial debt ratio of – say – 90% instead of 130% makes a difference of 0.4% of GDP in the level of the primary surplus that is needed to keep the debt constant. With an $r-g=2\%$, the difference would be 0.8%, still less than one per cent of GDP.

things can get, or the Weimar Republic, when the government's default on the real debt annihilated the middle class of Germany. ⁴

- e) I also doubt that there can be such a thing as an early restructuring. In the sense that no government will ever decide to restructure the debt unless it is already close to a state of default and bond prices have already collapsed; only then the government can offer a slightly better deal to bondholders. An early restructuring is a cold-blooded pistol shot in the heads of innocent savers. ⁵ It is much worse than bank fraud, for which there are penal responsibilities in all countries. The government cannot behave worse than Enron and Lehmann put together; in any case, if it does, it would be lynched by the populace, not only by the electorate. Besides, in Italy, as in most other countries, an early restructuring would likely be held in local courts to be unconstitutional, because the Italian judicial system is based on the rule of law and the protects property rights and, specifically, savings; expropriation is possible for reasons of public interest, but only with due indemnification.
- f) A moderate restructuring, i.e. one that does not cause a significant recession, may be appropriate in the context and as a complement of a package agreed with official creditors aimed at increasing the primary surplus. Actually, in such cases, a wealth tax would probably be more equitable, but it may be more difficult to implement. In any case, restructuring cannot be a substitute for fiscal responsibility.
- g) Such moderate restructuring in the context of a program can and should be done but in a discretionary fashion. Existing rules, namely the no bail-out clause and the requirement that the debts of countries applying for ESM support be sustainable, already provide a framework for such discretionary solutions, aimed primarily at avoiding moral hazard.

Finally, let me add that whatever we do now with ESM rules, it is crucial not to repeat the mistake that was done in 2010 in Deauville. When markets learnt about PSI, contagion effects were significant and markets were destabilized in several Eurozone countries. ⁶ For this reason, these issues must be handled with great care.

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⁴ Alesina (1988).

⁵ A preemptive restructuring, i.e. which occurs before technical default on some payments, may instead be useful in making the restructuring less disorderly and costly. See Asonuma and Trebesch (2015) and Sturzenegger and Zettelmeyer (2006).

⁶ Bini Smaghi (2018).

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