Perils of Precedent: Threat to the Sovereign Bond Market

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Key Themes

• **Sovereign debt crises** – are no longer reserve for emerging market economies.

• **A Pareto Optimal Approach** – to Sovereign debt is key for fairness to creditors and debtors.

• **Precedent matters** – present debt disruptions and negotiations will vitally influence the future cost of capital – even in the US.

“What happens in Athens or Buenos Aires does NOT stay in Athens or Buenos Aires.”
Sovereign Debt Management: Re-Gaining Direction

**The Goal**
A Pareto optimal approach...where creditors and debtors are both better off.

Source: Center for Financial Stability.

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**Concepts**
- Ability
- Willingness

**Monitor**
- Economic Capacity
- Rule of Law

Delays risk deeper crises!!!
The Way Forward for Sovereign Debt Management

The Economic Subcommittee (ESC) to Bank Advisory Committees during the Brady Debt restructuring era provides a guidepost for:

1) identifying common ground for the benefit of creditors and debtors alike and
2) paving the way for future growth.


Missed Opportunities: Argentina (2002), Ecuador (1987, 1995 and 2008), and Greece (???)
Economic Capacity: Three Pronged Program

Substitute Math for Rhetoric

**Economics** - restoring growth for a long-term solution...fiscal, monetary and FX policies.

**Official Institutions** - highlighting available official resources to support and ensure implementation of a successful program.

**Finance** - identifying sustainable levels of debt and potentially needed support for banks. Mobilize sovereign and private balance sheets.

Source: Center for Financial Stability.
Estimate of Greek Debt Reduction on European Banks (as calculated by on June 24, 2011***)

<table>
<thead>
<tr>
<th>Greek</th>
<th>Losses by banks (EUR bn)</th>
<th>Impact on capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debt Reduction ---›</strong></td>
<td>20%</td>
<td>40%</td>
</tr>
<tr>
<td>Europe</td>
<td>23.2</td>
<td>46.4</td>
</tr>
<tr>
<td>France</td>
<td>9.3</td>
<td>18.6</td>
</tr>
<tr>
<td>Germany</td>
<td>5.7</td>
<td>11.4</td>
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<tr>
<td>Italy</td>
<td>0.8</td>
<td>1.7</td>
</tr>
<tr>
<td>UK</td>
<td>2.7</td>
<td>5.4</td>
</tr>
</tbody>
</table>

*** “Solving the Greek Crisis” – June 24, 2011, Center for Financial Stability. Source: ECB, BIS Quarterly Review Database (June 2011) and Center for Financial Stability Inc.
The Next Stage: Currency Strains in the Euro

For every 25 point weakening of the RLI... expect a 200 basis point increase in bond yields!!!
Strength of US Institutions Helps Maintain Low Rates

Although a low probability event, a weakened market perception of US institutions could push rates up and add $250 billion per annum to US debt service over the long-term…Rule of Law Matters for Sovereigns.

Concluding thoughts…

• **Sovereign debt negotiations** must more readily incorporate a nation’s ability to pay.
• Enforcement of the **Rule of Law** will reduce the need for debt restructuring and hasten fair exchanges when needed.
• Together these measures will facilitate **capital formation** and keep the cost of capital low – globally.
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