Perils of Precedent:
Threat to the Sovereign Bond Market

Lawrence Goodman

President

Emerging Markets Trade Association

New York, NY

March 30, 2012

CENTER FOR FINANCIAL STABILITY

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.

Concepts		Monitor
Ability	→	Economic Capacity
Willingness	→	Rule of Law

Delays risk deeper crises!!!

Source: Center for Financial Stability.

CENTER FOR FINANCIAL STABILITY

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.

Successes: Brazil (1994), Chile (1988), Korea (1982 and 1997), Mexico (1990), and Poland (1994).

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.

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

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

Source: Center for Financial Stability.

Dialog • Insight • Solutions

Estimate of Greek Debt Reduction on European Banks (as calculated by on June 24, 2011***)

Greek	**Losses by banks (EUR bn)**		**Impact on capital**	
Debt Reduction --->	**20%**	**40%**	**20%**	**40%**
Europe	23.2	46.4	-1.1%	-2.2%
France	9.3	18.6	-1.9%	-3.8%
Germany	5.7	11.4	-1.5%	-2.9%
Italy	0.8	1.7	-0.2%	-0.4%
UK	2.7	5.4	-0.4%	-0.7%

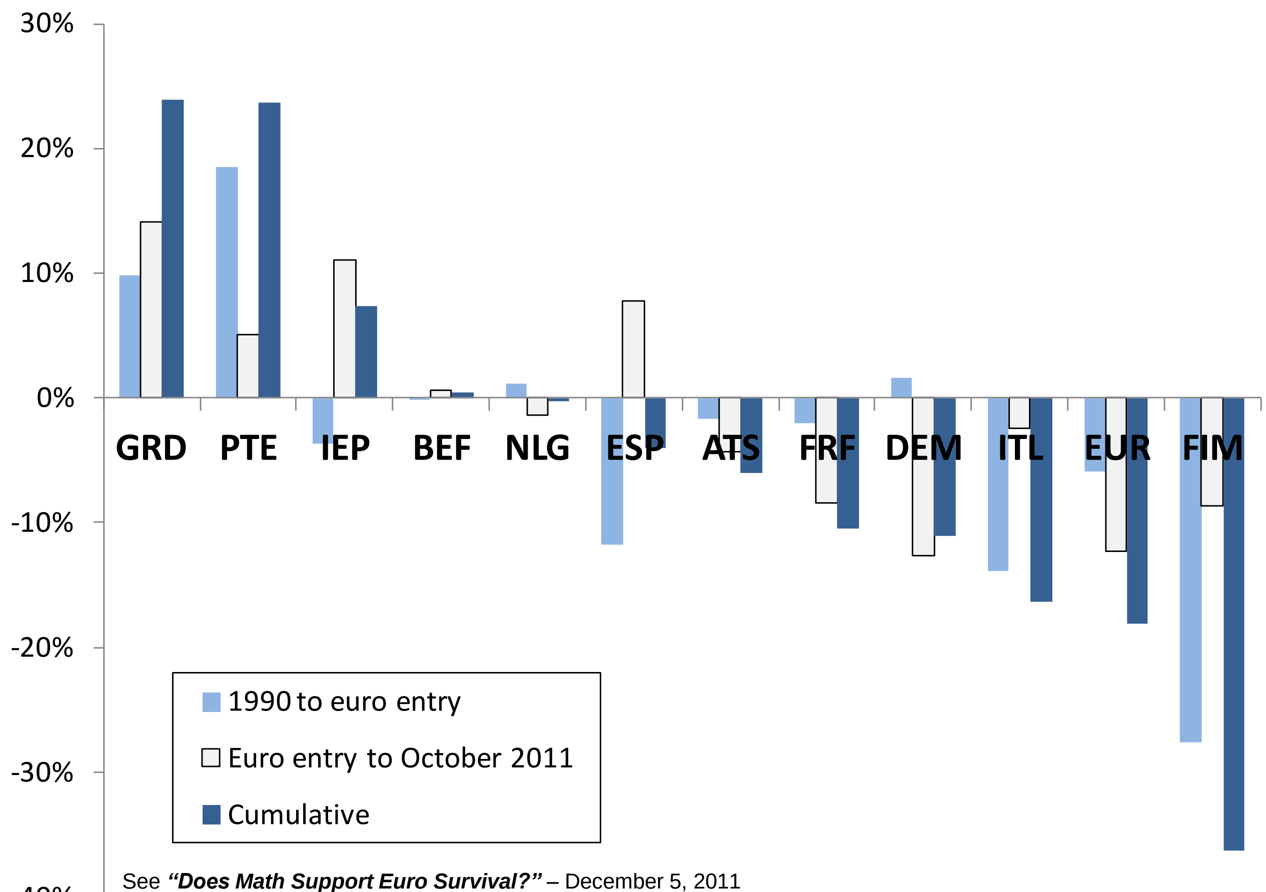
*** "Solving the Greek Crisis" – June 24, 2011, Center for Financial Stability.
Source: ECB, BIS Quarterly Review Database (June 2011) and Center for Financial Stability Inc.

CENTER FOR FINANCIAL STABILITY

The Next Stage: Currency Strains in the Euro

Real Appreciation / Overvaluation

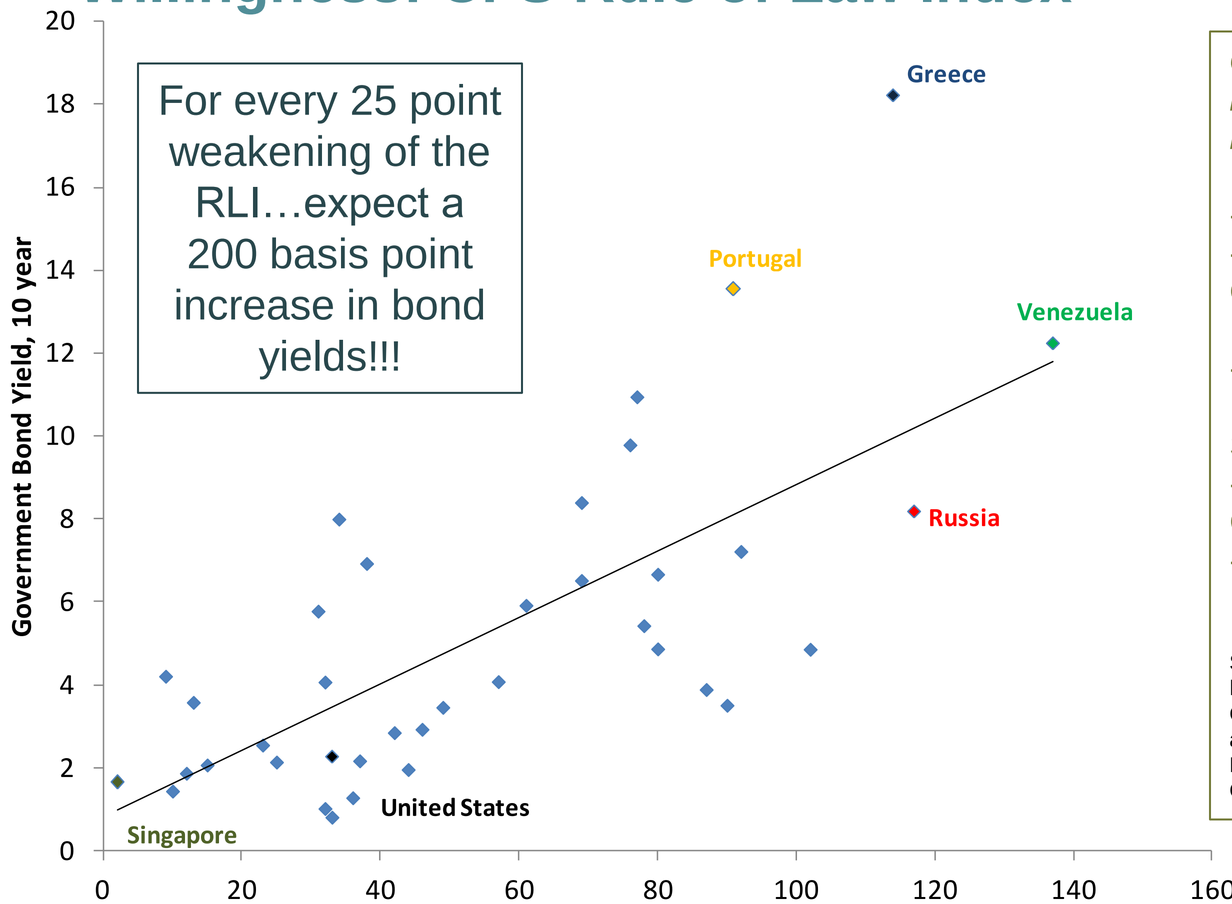
Real Depreciation / Undervaluation



See ***"Does Math Support Euro Survival?"*** – December 5, 2011
Source: International Financial Statistics, Direction of Trade Statistics, and Center for Financial Stabilitywww.CenterforFinancialStability.org/euro.php (CFS real exchange rates incorporate 48 nations)

CENTER FOR FINANCIAL STABILITY

Willingness: CFS Rule of Law Index



Strong ⟵ CFS Rule of Law Index ⟶ Weak

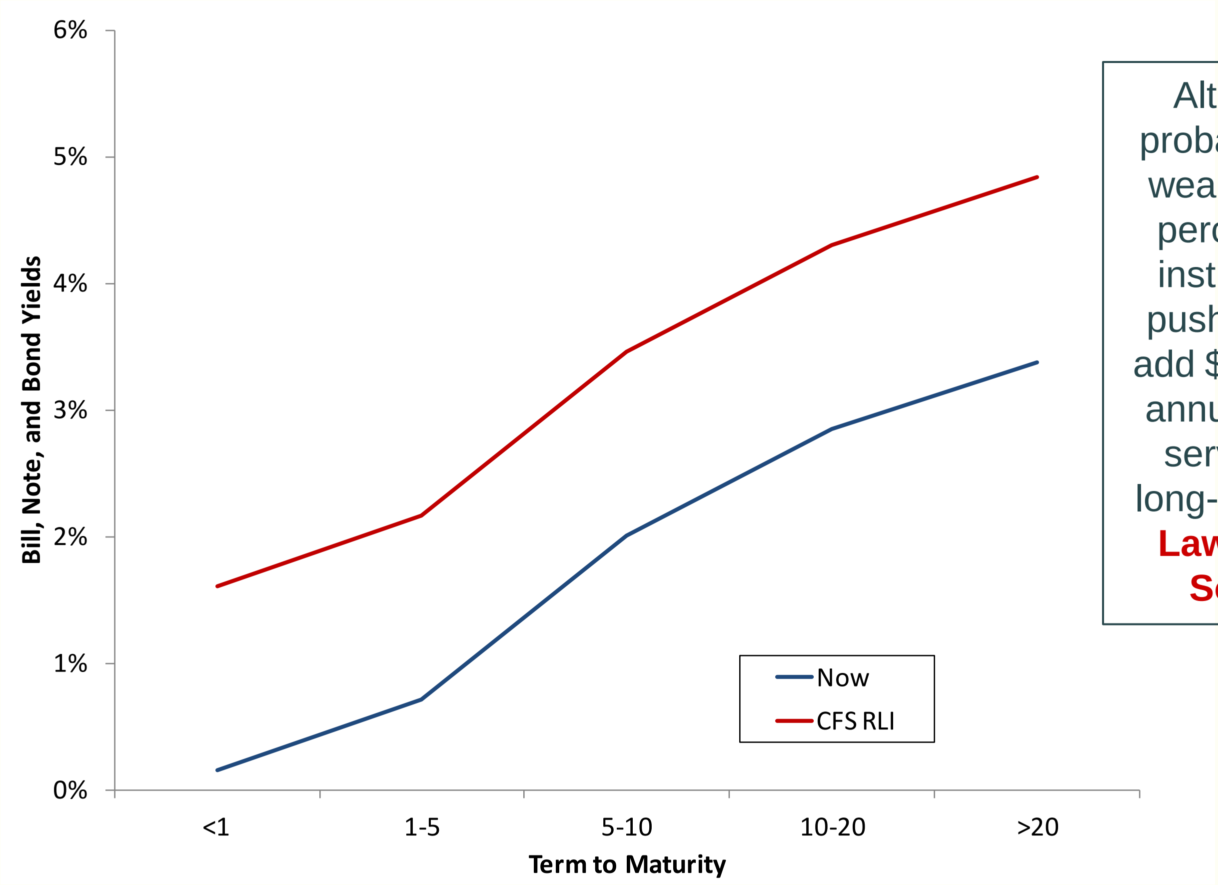
CFS Rule of Law Index (RLI) is based on:

- Property Rights
- Burden of Government Regulation
- Efficiency of Legal Framework in Settling of Disputes
- Efficacy of Corporate Boards
- Strength of Investor Protections

Source: World Economic Forum's Global Competitiveness Index (GCI) and World Bank/International Finance Corporation, and Center for Financial Stability.

CENTER FOR FINANCIAL STABILITY

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**.

Source: US Treasury, Datastream, and Center for Financial Stability.

CENTER FOR FINANCIAL STABILITY

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.

About CFS and Disclosure

The Center for Financial Stability (CFS) is a private, nonprofit institution focusing on global finance and markets. Its research is nonpartisan.

The CFS is dedicated to the integration of finance, law, and economics. The organization is unique, as it focuses on market mechanics and linkages while serving as a private sector check on government actions.

This publication reflects the judgments and recommendations of the author(s). They do not necessarily represent the views of Members of the Advisory Board or Trustees, whose involvement in no way should be interpreted as an endorsement of the report by either themselves or the organizations with which they are affiliated.

The organization's website is **www.CenterforFinancialStability.org**.

The Center for Financial Stability is a non-profit 501(c)(3) organization formed for educational purposes.

CENTER FOR FINANCIAL STABILITY