OLD SINS AND LONG SHADOWS

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Old sins cast long shadows. In the world of sovereign debt, so apparently do new ones.

It used to be that the period of time that elapsed between a serious policy mistake and the punishment for that transgression was generous—at least long enough to allow the erring politicians to exit with a valedictory speech along the lines of "just remember that everything was okay when I left." Moralists must surely be pleased that one of the byproducts of modern financial integration is the speed with which fiscal policy mistakes are punished by the terrible, swift sword of market sentiment. Take the first deadly sin of fiscal policy: the decision to cover chronic budget deficits through borrowing, as opposed to the politically less popular measures of taxation or curtailment of public services. Once upon a time politicians could peddle deficits-don't-matter fairy tales for decades before the day of reckoning arrived in the form of sovereign downgrades, higher borrowing costs, and constrained market access. That period is now measured in years, occasionally (and embarrassingly) overtaking the very politicians who had spun the cotton candy in the first place.

Sovereign debt is less forgiving than corporate or personal debt. An overextended corporation or individual can, *in extremis*, dip itself into the cleansing waters of a statutory bankruptcy proceeding. Sovereigns do not have that option. Sovereign debts are, from a legal standpoint, ineradicable unless the sovereign can cajole or bludgeon its creditors into accepting less than what was originally owed. So when politicians elect to smooth their own few fretful hours upon the political stage by borrowing to cover chronic deficits, they leave their successors to choose among four unpalatable options: (i) inflate the resulting debt stock away, (ii) restructure it, (iii) default and repudiate, or (iv) accept sharply lower living standards in order to pay off a legacy of inherited liabilities for which there are not even corresponding assets—such as bridges, roads or first-rate school systems—to assuage a sense of intergenerational larceny.

Sovereign debt crises were, until about two years ago, viewed much like tuberculosis—an affliction endemic to emerging market economies that had been all but eliminated in the developed world. No one thinks that in 2012. The infectious indiscipline that has characterized the fiscal policies of the United States and much of Europe over the last decade has brought the world economy to its most fragile point since 1930. And these sins, while perhaps not wholly inexpiable, will cast a shadow that will darken the lives

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of the citizens of these countries for many years. Those people will inevitably pay more taxes, enjoy fewer benefits, and be forced to work longer than the authors of their predicament.

We have not only left them to repay our debts, but we have also failed to produce, despite thirty years of sporadic efforts, a viable model for administering an efficient sovereign debt workout process. It is possible, of course, to extrapolate from the fifty or sixty sovereign debt restructurings that have been undertaken over the last three decades some basic rules about which measures facilitate, and which retard, such an operation. But even armed with these lessons, there is considerable uncertainty about how any looming sovereign debt workout will proceed. What will its short and long-term consequences be? How much debt relief is enough and how much is too much? How can appropriate intercreditor equity be achieved? A sovereign debtor fears these and other uncertainties, as will its creditors and official sector sponsors. The result can be harmful delays in launching the process and embarrassing policy flip-flops along the way.

Best (and most recent) example? Europe circa 2010–12.

When announcing a complete bailout of Greece and its private sector bondholders in May of 2010, European political leaders signaled that a sovereign debt restructuring would be too humiliating, too contagious, and too unpredictable to be tolerated in the belly of Europe. Six months later, in October 2010, as folks were waking up to the fact that bailing out bondholders meant bailing *in* taxpayers, President Sarkozy and Chancellor Merkel announced that financial assistance packages for distressed European sovereigns would *require* a restructuring of claims held by private sector investors (dubbed "private sector involvement"). A month later, this policy was revised to state that private sector involvement in sovereign debt workouts would be deferred until the middle of 2013. That version of the policy lasted eight months until Greek bondholders were told, in July 2011, that they would have to stretch out—by thirty years—their claims against that beleaguered country. Three months later, in October 2011, those same Greek bondholders were instructed by European politicians to "voluntarily" write off fifty percent of their claims, in nominal terms. And two months after that, in December 2011, Merkel and Sarkozy swore off *any* private sector involvement in European sovereign debt situations, except, of course, for that unique and exceptional country of Greece, where they said the fifty percent private sector write-off was still expected. From this mangled history, the market must attempt to divine future European policy toward sovereign debt workouts on that continent.

It is in pursuit of a workable model for resolving sovereign debt problems that this issue of the *Harvard Business Law Review* is devoted. Excessive sovereign debt buildups in major developed economies, and the tools to address those problems, will surely be a central focus, perhaps *the* central focus, of the international financial community in this decade.