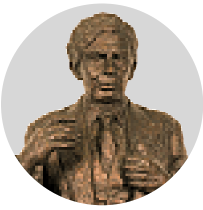
An open letter to the minister of finance of Ruritania *Lee C Buchheit*



The Bracken column is named after Brendan Bracken, the founding editor of The Banker in 1926 and chairman of the modern-day Financial Times from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.

DEAR MINISTER,
There is no easy way to say this – Ruritania is broke. It is not merely illiquid, whatever that means. It is not just experiencing temporary financial distress or enduring a bad patch. In truth, Ruritania has accumulated a debt stock that under even the most benign growth assumptions can never be repaid. Unless that unsustainable debt stock is addressed, it will blight the economic prospects of Ruritania for generations.

Dozens of countries have had to face this same situation over the past 30 years. Some have done it well and emerged from their debt crises quickly. Others have mangled the process and found themselves mired in financial crisis for years, like a bellowing mastodon stuck in a prehistoric tar pit.

This history teaches one important lesson. Pathological procrastination by the sovereign debtor in acknowledging the severity of its problem and commencing the necessary workout process can make the ultimate resolution of the crisis far more costly for all concerned – the sovereign debtor, its citizens and its creditors. But every atom of the debtor's political flesh will cry out to delay a process that is never pleasant and can often be incandescently painful. Deferring debt restructuring until the next government takes office is, of course, the most tempting option.

DENIAL AND DELAY

In today's world, a politician's instinctive preference for denial and delay may receive encouragement from unexpected quarters. The creditors will naturally want to put off the day of reckoning as long as possible. To this end, creditors will alternately flatter ("proud Ruritania has always stood as a champion of the sanctity of contract") and bludgeon ("we shall neither forgive nor forget a default") the Ruritanian government into paralysis.

Denial and delay may also be urged by Ruritania's neighbouring countries, which may fear contagion and market turmoil as a result of a Ruritanian debt restructuring. If those neighbours fear it enough, they may even offer to lend Ruritania all the money it needs to continue servicing a visibly unsustainable debt stock. That path lends inexorably to the visibly unsustainable debt stock being owed to bilateral and multilateral creditors.

The proponents of inaction will never publicly concur with the proposition that a sovereign debt stock has reached the point where a restructuring is the only feasible option. Frugality, discipline, sacrifice and patience, they argue, will eventually remedy any problem. But this is also when fairy dust and a profound belief in the efficacy of prayer may enter the picture.

PRAYER IS NOT AN OPTION

If we allow economists to assume in their mathematical models the watchful presence of a Merciful Providence, then any sovereign debt stock can be judged sustainable. Even economists from the International Monetary Fund, under pressure from some of its more influential shareholders, have been heard to clap for Tinkerbell when preparing debt sustainability analyses.

My advice, minister, is that you:

- Disregard any debt sustainability analysis that assigns a greater than 50% probability to the occurrence of the second coming of Christ before the next bond maturity.
- While avoiding unrealistic optimism, do not careen to the other extreme of soul-destroying despair. A request for financial assistance addressed to the executive board of the IMF should not begin with the sentence: "The last camel died at noon." Panic is as infectious as yawning. So, however, is a sense of composure and control.
- Once it becomes clear that the debt stock must be addressed, get on with it. Creditors may not like the prospect of having to write off a portion of their claims or defer repayment dates, but they positively loathe prolonged periods of indecision and dithering. Efficiency, discipline and fairness, even in carrying out a disagreeable task, will be remembered by markets long after the financial pain of a sovereign debt restructuring has been forgotten.

A sovereign debt crisis is just that: a crisis. It does not have to become a catastrophe. TB

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