I would like to start by thanking the Committee and Chairman Cabrita for inviting me to participate in today’s important hearing on public debt. I will focus my remarks on the economic aspects of restructuring sovereign debt.

When discussing a sovereign debt restructuring, it is important to recognize that conducting one is merely a means to an end, and that a debt restructuring cannot meaningfully be viewed as a goal in itself. It can only serve the purpose of helping to reduce the overall burden of public debt in advanced economies, where generally the sovereign cannot declare bankruptcy.¹ A sovereign debt restructuring is, however, only one of several ways in which a country’s public sector burden can be reduced, and meaningful cost-benefit analysis must consequently consider also alternative and complementary ways to achieve this aim. This is particularly critical in light of the historical crisis regularity that sovereign debt restructurings do not take place in a vacuum, but with multiple other economic changes occurring in a country at the same time.

There are at least six general and one additional euro area specific way in which a country can hope to reduce its public sector debt burden. Historically, countries have had to deploy several of these methods simultaneously, as any single one is rarely enough to sustainably reduce the public debt burden. I will now discuss the seven methods in more detail.

1) **Rapid Economic Growth** Growing out of debt problems is generally the politically preferred and sociably pain-free option for societies suffering from large public debt burdens. It was used successfully in Europe after World War 2. However, advanced economies today face demographic changes and operate near the “production frontier,” where rapid catch-up growth from technology adoption from more advanced economies is not an option. Accordingly, it would be a mistake to expect real potential growth rates in most advanced economies, including Portugal, to exceed 2 percent. This makes simply growing out of any debt problem for this group of countries unrealistic, though at the same time, achieving at least stable low growth is imperative to achieve any degree of long-term public debt sustainability.

¹ Bankruptcies are possible at the subnational level among state and local government entities, however.
Portugal, as a consumption-rich country—which even before the crisis grew very slowly (less than 1 percent on average from the euro introduction to 2008) and failed to utilize the dramatic post-1999 decline in real interest to boost investment levels—should place particular importance on this issue. Portugal’s historical growth difficulties suggests that whether it chooses to restructure its public debts or not, it will not escape the need to implement a comprehensive structural reform program of the nature of the post-2011 troika program to increase its potential growth rate.

2) **Sustained Fiscal Consolidation** This is an integral part of the traditional International Monetary Fund (IMF) approach to dealing with excessive public sector debt burdens and typically includes substantial reductions in government spending levels, increases in tax revenue, and privatization of public assets. While on the one hand, fiscal consolidation is detrimental to short-term growth prospects due to the negative fiscal multiplier (estimates of the size of the multiplier varies, but almost all studies suggests that it is higher than zero in the short run), it is nonetheless often necessary to restore market confidence in a country, avoid a downward spiral, and stabilize a crisis situation. Moreover, unless government finances are put on a more sustainable course, it is generally difficult post-crisis to restore private sector investments and job creation.

For a country like Portugal, which has since 1999 run an aggregate more than 2 percent of GDP primary deficit (in 2010 in the run up to the crisis the primary deficit was about 7 percent of GDP), it must moreover be evident that a substantial fiscal consolidation has been and will continue to be avoidable. Even today in late 2014, Portugal is merely close to primary budget balance, indicating that any material future fiscal loosening would jeopardize the country’s sustainable budget path. Without a sizable ex ante primary surplus, even a hypothetical complete debt repudiation would not create the budgetary space necessary to engage in large scale fiscal stimulus.

3) **Creating Surprise Inflation** Historically, governments have reduced the real value of their domestic currency debt by generating a sudden and substantial increase in the level of inflation. The real value of longer-dated debts can hereby be reduced, though it will likely not be possible for governments to save much on shorter maturities, as investors will demand higher interest rates in return for debt rollovers. Consequently, generating inflation can hope to lower the value of only the longer maturity segment of a government’s debt. In addition, any foreign currency debt will not be affected (unless the sudden inflation shock is global in scope).

As a member of the euro area, it is not straightforward for Portugal to suddenly increase its level of domestic inflation, and especially not right now when the entire global economy is plagued by deflationary pressures and low demand. In general therefore, generating sudden inflation is not a feasible policy to lower the public debt burden inside a monetary union with a completely independent central bank. Lastly, it should be recalled that generating inflation would be a highly regressive policy, which would disproportionally hurt lower income groups who consume most of their incomes to sustain themselves.
Debt Monetization

Debt monetization occurs when the central bank purchases all or parts of the government debt, pays existing owners (or the government directly) in cash and subsequently converts the government debt into, for instance, perpetual debt (e.g. with no repayment requirement) with zero interest. This procedure may begin with nonstandard monetary policy measures like sovereign bond purchases as part of quantitative easing (QE) by central banks, as has recently taken place in the United States, the United Kingdom, and (ongoing) Japan. Once the debt is on the central bank balance sheet and hence inside the general government sector, it can either be sold back to private investors (e.g. quantitative easing reversed), be retired (e.g. the government simply annuls it), or as in the example above be converted into a new type of debt that the government will never have to repay. Debt monetization entails two major risks; first, that the associated increase in the money supply leads to an increase in inflation (per #3 above), even if bank regulators through capital levels and reserve requirements may limit the private sector money multiplier at the same time; and second, that once debt monetization has been used once, it will prove politically irresistible not to repeat it again in the future—only next time with even higher resulting inflation.

For Portugal, as a member of the euro area, debt monetization is not an immediately available option, though the country will have a voice in deciding what to do in the future about any sovereign bonds that the European System of Central Banks (ESCB) may begin to purchase soon in 2015 as part of its monetary policy.

Financial Repression

This refers to a set of government policies that seek to direct lending/credit from captive domestic private actors to the government at lower interest rates than free-market risk-based pricing would dictate and thereby lower the government's cost of debt. It can take more or less coercive forms ranging from (most coercive) government nationalization of private pension funds and capital controls to (less coercive) caps on banks’ deposit interest rates and tax benefits for holding government debt.

For Portugal inside the European Union and euro area, some types of financial repression will be in conflict with the internal market and other EU regulation, and the recent creation of the Single Supervisory Mechanism (SSM) has further greatly reduced the ability of any national government to implement such policies.

Debt Default/Restructuring/Re-profiling of Privately Held Government Debt

This option is the most direct way to reduce the public debt burden by either the government unilaterally declaring default on all or parts of its debt, agreeing with its creditors about a voluntary restructuring (e.g. reduction of the principal) of the debt, or agreeing with creditors about a voluntary re-profiling (e.g. extending the maturity/lowering of interest rate) of the debt. In early 2012, the Greek government restructured its privately held sovereign debt through a complex transaction, which resulted in the reduction in the net present value of the affected debt by about €100 billion. The details of the Greek
example, which is the only sovereign debt restructuring that is of any real relevance for Portugal today, are too numerous for me to go through here, except to note four important elements:

- In the years since the crisis began, Greece has lost about 25 percent of its GDP and as such can in no way be said to have avoided the most severe economic depression by restructuring its sovereign debt;
- The Greek debt restructuring was possible only though the continuous and large-scale financial support of its euro area partners and the IMF;
- The Greek government (and many if not most private Greek businesses) lost and have not yet regained full bond market access since the restructuring; and
- Many private foreign bondholders of Greek debt were able to sell their debt holdings before the restructuring took place, leaving a disproportionate share of the privately held debt in Greek domestic hands in early 2012.

It will be clear from these four points that the Greek debt restructuring in 2012 may in my opinion well have been inevitable but was nonetheless such a traumatic economic experience for Greece that other countries’ are best advised not to seek to emulate it, except in the most desperate ultima ratio circumstances.

Several important general issues are further invariably associated with any modern sovereign debt restructuring. First, due to the traditional assumption of government debt as being a “risk free asset” (with a zero risk weighting in banks’ capital structure in addition), any restructuring will impose a loss on/reduce the asset value of someone else, as no one ex ante makes provisions for credit losses in sovereign debt. This issue is of particular relevance for countries—like Portugal—with relatively high domestic ownership of the debt, as “balance sheet holes” would invariably be created elsewhere in the Portuguese economic by a sovereign debt restructuring. This could especially hamper the ability of the Portuguese banking system to withstand credit losses from its portfolio of private sector loans, which given the highly leveraged status of the Portuguese nonfinancial sector today would be a serious threat to medium-term growth prospects (and thus future government revenues).

Secondly, any sovereign debt restructuring is highly redistributive in any society, due to the differences between the domestic ownership base of the debt and the recipients of the government services financed by it. This will typically involve transfer between older and asset owning groups in societies to younger and less affluent groups.

Thirdly, any sovereign debt restructuring—particularly if initiated unilaterally—will result in a lengthy loss of bond market access for not just the sovereign in question, but also for the overwhelming majority

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2 Too often the debate about sovereign debt restructurings is obscured by irrelevant historical examples from the 18th, 19th, and early 20th centuries. Sovereign debt restructurings in those times took place under completely different and generally undemocratic political circumstances, and often involved sovereign governments, whose budget accounted for a very small share of national GDP. Drawing any inferences about the economic impact of a debt restructuring by a sovereign responsible for a modern welfare state often accounting for up to 50 percent of GDP from such distant historical resemblances is patent nonsense and should be avoided.
of the private sector in the restructuring country. This means that unless the sovereign has access to foreign financial assistance in the aftermath of a restructuring or has and can maintain a primary surplus, it will immediately be compelled to operate on a “cash basis,” meaning it must immediately balance expenses and revenues on an ongoing basis. In most cases, this would entail the automatic imposition of substantial cuts in public services. In a country like Portugal, which currently has substantial private sector foreign indebtedness (net international investment position at about –115 percent of GDP), the inability of most of the private sector to access bond markets following a sovereign debt restructuring poses a further critical economic risk.

7) **Sovereign Debt Mutualization (Euro Area Only Option)** The European Union and euro area in particular is a unique experiment in shared sovereignty, which in Europe has produced the most politically, economically, and financially integrated regional entity in the world. As has been recently illustrated with the launch of the banking union, European integration is an ongoing process, which can quickly take surprising and far-reaching new forms. To date there has not been any explicit political movement in Europe or the euro area towards the complete or partial mutualization of national sovereign debt into eurobonds, though this could in principle—due to the relatively low aggregate sovereign debt levels in Europe—greatly alleviate the debt burden of the most indebted countries in Europe, including Portugal. The political reasons for this are straightforward and well-known and need not be repeated here. However, in recent years events have unfolded that nonetheless could conceivably in the near future (e.g during the maturity of currently outstanding national sovereign debt in the euro area) lead to euro area de facto debt mutualization in several potential forms. They are consequently of relevance to the debate in Portugal today.

Unlike the privately held debt discussed above in #6, this concerns the national government debt currently or prospectively held by the official sector euro area institutions in the European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) (European Financial Stabilization Mechanism [EFSM]) and the European Central Bank (ECB). Three distinct types of mutualization of this debt can be imagined and has indeed already arguably in one case commenced.

- **Fiscal Debt Mutualization through the EFSF/ESM (EFSM)** This involves these pan–euro area fiscal entities initially lending to national governments in crisis and subject to various political conditionality. However, subsequently the loans/bonds are restructured in such a manner as to resemble “close to perpetual debt at concessionary interest rates,” greatly reducing the net present value of the debt for the borrowing government. This is a process that has already been initiated with the maturity extension of Greek, Portuguese, and Irish loans in 2012–13 and seems likely to be repeated in the future so as to ensure the financial situation of recipient member states in general compliance with euro area economic policies. Fiscal debt mutualization, however, is inherently limited to financial scope of the ESM/EFSF (EFSM).

- **Monetary Debt Mutualization through the ECB/ESCB** Basically resembling the process discussed in #4, monetary debt mutualization in the euro area would involve the ECB/ESCB purchasing some quantity of privately held sovereign debt in the euro area as part of its conduct
of monetary policy. Subsequently, once the debt has been purchased by the ECB for monetary policy purposes, it can essentially be treated in whatever way the euro area monetary authorities and political leaders see fit. In principle, the ECB’s balance sheet has the potential to operate as the functionally equivalent of a eurobond. It is as a result, the design of the exit from quantitative easing is of potential long-term relevance. Options range from a strictly temporary effect through simply letting the purchased bonds mature and then gradually reduce the ECB stock of sovereign debt (as currently with the Securities Market Program program holdings) to full debt monetization through a conversion of the purchased debt into perpetual zero interest rates debt.

- **Parliamentary/Treaty-based Debt Mutualization** This would involve the legal creation of new mutual debt instruments in the form of euro bonds though a major revision of the existing EU Treaties.

As noted at the outset, any country contemplating a sovereign debt restructuring will in reality be faced in a crisis with the need to engage in most if not all of the seven different policy types listed. The operational political question hence becomes one of the appropriate balance between the different policies in question and whether crossing the legal threshold into a sovereign debt restructuring is warranted or not.

As suggested by the preceding analysis, Portugal cannot in my opinion—regardless of whether it chooses to restructure its public debt or not—avoid the need to continue the far-reaching structural economic reforms and sustained fiscal consolidation initiated with the Troika program in 2011. Moreover, Portugal inside the euro area today does not have realistic options to materially lower its debt burden through the sudden creation of inflation or financial repression.

A restructuring of Portugal’s privately held sovereign debt would—as it was in Greece—in my opinion be highly disruptive for Portugal’s economy and in the end will not return the country’s wealth and social welfare levels to prerestructuring levels. A sudden and unilaterally initiated public debt restructuring without the full consent and cooperation of the rest of the euro area would be tantamount to economic and political suicide for Portugal, which would in all probability reverse many of the societal gains witnessed since 1974.

In political terms Portugal would be reneging on its solemn sovereign commitments to its euro area partners, where the burden would be felt most acutely among fellow struggling members like Spain or Italy (whose combined weight in the ESM/EFSF and ESCB exceeds Germany), rather than among wealthier and currently more stable euro area members like Germany, who would be better able to afford the associated financial losses imposed upon them by the Portuguese decision. Political isolation from its neighbors and Europe would be the inevitable political result of such a unilaterally initiated debt restructuring.

Meanwhile, the economic fallout would be unambiguously catastrophic, as the Portuguese banking system would immediately lose access to ECB liquidity and thus immediately face a funding crisis.
Without assistance from the ECB and the euro area, Portugal would be powerless to react to what would likely be rapidly unfolding bank runs, as retail and small business depositors would rationally seek immediate access to their personal and SME working capital savings. Once the Portuguese banking system had collapsed, the domestic economy would rapidly follow with deep recession and unavoidable mass unemployment.

National policymakers nonetheless contemplating a debt restructuring must further be aware that their negotiating situation today is very different from 2010–11, when the Greek crisis began. Unlike then, the risk today of cross-border contagion from one member state to another is very small in the euro area, due to the creation of credible crisis management institutions like the ESM and ECB Outright Monetary Transactions in recent years. As a result, national policymakers no longer have a credible threat to potentially destabilize the entire euro area from launching a potential unilaterally initiated debt restructuring. Unlike in 2010–11, the euro area today has the institutions it needs to protect its financial stability. The rest of the euro area can in other words not be blackmailed into consenting to granting any individual member state the lenient debt restructuring terms its national policymakers might desire. Attempts to push such hardball negotiating positions by national policymakers of any euro area member are doomed to fail.

Let me summarize by stating that I believe Portugal is best served by broadly continuing the policies pursued since early 2011, though with the short-term fiscal and monetary stance appropriately adjusted to the present regional circumstances. Pursuing instead a strategy of public debt restructuring in Portugal, especially if unilaterally initiated, would be a very, very costly national policy error.

Lastly, let me note that I believe Portugal and its parliament must be greatly commended for initiating this critically important national debate on the issue of public debt in Portugal. It speaks to the open and democratic character of Portuguese society that all views are invited and heard on this issue of far-reaching societal importance. Yet, at the same time, it must be clear that a constant national debate of an issue with as far-reaching implications as a sovereign debt restructuring is not without its own consequences and may lead especially casual foreign market observers to waiver in their belief in Portugal’s ultimate willingness to fully honor its national commitments.

I therefore encourage the Portuguese people and its representatives to have an open, honest though not too prolonged debate about the future of its public debt—a debate I am sure once the costs and benefits of all positions are evaluated will yield a result along the lines advocated in my comments today—and then reach a well-informed democratic decision once and for all and no longer redeliberate this set of issues in the future. Portugal will greatly benefit from such clarity of mind going forward.