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Europe's Debt Problems Cannot Be Ignored

By Martin Gilman

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The echoes of Russia's debt default in 1998 — which is now, fortunately, of mere historical interest as seen from Moscow — seem to reverberate worryingly in Europe.

The numbers are ominous. Just this year, the three largest economies in the euro zone have $1.08 trillion in maturing public bonds that will have to be repaid or refinanced. Italy alone accounts for $428 billion. Its debt due is the equivalent of almost 100 percent of last year's exports estimated by the International Monetary Fund. And this figure does not include interest payments on its stock of public debt, which amounts to another $72 billion, according to Bloomberg.

Meanwhile, Russia owes only $13 billion, by far the lowest amount due among the world's 10 largest economies and significantly less than the $169 billion for Brazil or the $121 billion for China. What Russia owes this year amounts to less than 3 percent of last year's exports or of the current stock of foreign exchanges reserves held by the Central Bank of Russia.

It is almost as if the tables have turned 180 degrees from the world we knew just a decade ago. The point of immediate interest is what can we expect now?

Russia, a debt-financed fiscal basket case of the 1990s, is now a poster child of debt abstinence and fiscal prudence with a budget surplus last year of 1 percent of GDP. Meanwhile, Russia's erstwhile creditors of that earlier period keep accumulating ever more debt in order to repay amounts falling due just to keep their economies from stagnating. The United States must repay $2.78 trillion of public debt this year and Japan some $3 trillion, and both must pay interest and borrow yet more to finance unending budget deficits.

Global economic sentiment has been unsettled since Greece's first debt bailout package grabbed headlines starting in May 2010. Since then, Europe's euro-denominated debt problems have escalated beyond Greece and the economic outlook has deteriorated, with recession spreading from southern to northern Europe.

Meanwhile, political systems have proven dysfunctional in indebted economies on both sides of the Atlantic, as politicians in both the United States and Europe have failed to reach internal consensus on how to cut budget deficits and spur growth. Unsurprisingly, markets remain nervous. The optimism of recent weeks, thanks in large part to an aggressive stance by the European Central Bank to provide emergency liquidity to banks, will no doubt be short-lived as Greece enters a debt vortex.

It is sobering to think that there will be further complications from Europe as it repeats the same mistakes that Russia made in the mid-1990s. At that time, Russia's fiscal policy remained loose, while monetary policy was being tightened. This inconsistency caused interest rates on short-term government bonds, known as GKOs, to soar until the burden became unbearable and could no longer be rolled over.

Peripheral European countries are now in a somewhat similar situation, as the European Central Bank's monetary policy looks too tight relative to their still too loose fiscal policies. If the European Central Bank relaxes its monetary policy further by providing more liquidity to banks, as expected later this month, it would be more consistent with the tightening, but still expansive, budget policies in some European countries.

Whether this could actually work is another issue. On the contrary, even more chaos would be likely over time, since interest rates would remain negative in real terms, thus creating more distortions. The massive bouts of quantitative easing orchestrated by Russia's Central Bank in the early 1990s created the preconditions for a perfect storm in August 1998.

Similarly the debt conundrum in Europe has not been resolved, or even clearly addressed. The main debate centers on whether to provide a bailout financial package with a dispute between those who worry about moral hazard and those who fear the consequences of a bankruptcy. One solution is for a massive transfer of funds from northern Europe to the south, but politicians in the north understandably fear this will cause a political backlash. It is part of a long chain reaction in which debtors, failing to repay their debts, threaten the solvency of banks. These banks, in turn, have to be rescued by governments, some of which have their own serious solvency problems, and then, the near-bankrupt nations must be rescued by bigger governments and the IMF.

Thus, history seems to be repeating itself as some heavily indebted advanced economies are heading toward the edge of the precipice. Russia has since moved in the opposite direction, toward positive real interest rates combined with relatively strong growth, low leverage and both current account and fiscal surpluses.

Again, the Russian experience remains relevant. In the summer of 1998, as the Russian government faced increasing difficulty to refinance maturing debt at a sustainable yield, some investors pretended that the problem could be resolved by buying time for the IMF-backed fiscal measures to work. They also argued that the Central Bank should monetize the debt maturities if necessary, since they were all issued in rubles. Similar arguments are heard in some quarters of the euro zone today.

Given this option, why did Russia default on its ruble-denominated treasury securities in 1998?

If, in fact, a sovereign debt crisis can be averted by the central banks printing money to refinance the maturing bonds that governments cannot afford or are unwilling to pay, why didn't the Russian government simply monetize the existing GKOs? Couldn't they hold rates down to say 10 percent instead of letting them top out at more than 200 percent?

Presumably, in opting for what they saw as the lesser of two evils, then-Prime Minister Sergei Kiriyenko and his colleagues were more concerned about the economic fallout and political consequences that hyperinflation would have on Russians.

What would Russia be like today if the Central Bank had monetized? Ironically, the country chose to default on its local currency debt — much of it held by nonresidents — and decided to pay in full their hard-currency euro bonds.

As the Russian experience of the 1990s showed, solving a debt crisis with more debt does not work. Anyone who had lived through Russia's debt default of August 1998 would be astounded by the country's new status as a role model, despite its other faults.

The Russians had to learn the hard way, and they have been inoculated ever since. Too bad others have chosen to ignore that experience.

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