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## Banks, Governments, and Debt Crises

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# Banks, governments and debt crises

by Anna Gelpern



Chief executive officers of financial firms who became household names after the near-collapse of the financial sector in fall 2008 testified during the House Financial Services oversight hearing of the Troubled Assets Relief Program (TARP) in Washington, D.C., on February 11, 2009. They are, from the left, Lloyd Blankfein of Goldman Sachs; Jamie Dimon of JPMorgan Chase and Co.; Robert P. Kelly of the Bank of New York; Ken Lewis of Bank of America; Ronald E. Logue of State Street; John Mack of Morgan Stanley; Vikram Pandit of Citigroup; and John Stumpf of Wells Fargo. (SCOTT J. FERRELL—CONGRESSIONAL QUARTERLY/GETTY IMAGES)

**T**HIS IS the familiar story of the financial crisis: With deregulation at home, an influx of capital from abroad, and a wave of financial and technical innovation, firms in the U.S. and Europe made increasingly risky investments. In 2007–2008, these investments went sour, so that many of the world’s biggest and most interconnected financial institutions teetered on the brink of failure. Had they failed, credit would have collapsed, along with national and cross-border payment systems, causing unprecedented wealth destruction and human suffering. Governments stepped into the breach with emergency loans and capital infusions; this helped avert catastrophe. But governments faced political backlash for bailing out the bankers. And most financial institutions, while grateful for the lifelines, resented the limelight and legal constraints that came with public money. Once the system had stabilized, governments pursued law reform to reduce the risk of future crises and bailouts. Meanwhile, as

soon as the private markets reopened, financial institutions rushed to raise funds to repay governments and get out from under the public yoke. If all goes well, taxpayers will be rid of banks, and financial institutions will be rid of bureaucrats.

This happy ending is a fiction. Financial institutions and governments the world over have been locked in mutual dependence since long before the crisis that began in 2007. The crisis has brought them even closer together. Postcrisis reforms will not rid banks and governments of one another; at best, they may renegotiate the terms of engagement and make both sides more transparent and accountable. Whether such an outcome is likely is an open question.

Two enduring links between financial institutions and

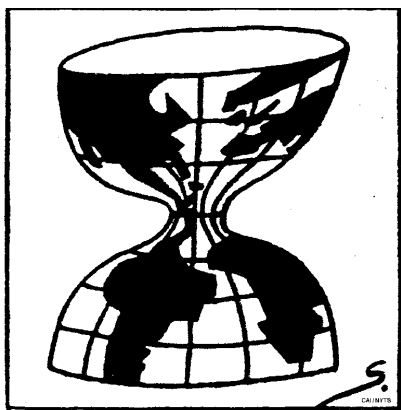
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governments merit particular attention. The first link is well-known: the formal and informal government insurance that banks, and a growing number of other financial firms, enjoy in exchange for providing critical services such as mobilizing popular savings and allocating credit, operating payments systems and helping transmit monetary policy. The second link has received less publicity to date, but is gaining prominence from the European financial crisis of 2010: financial institutions operate under powerful economic and regulatory incentives to hold government debt. When governments are short on funds, they often turn to regulated financial firms for help; and when governments default, they may bring down with them large portions of the financial sector. In sum, an increase in government debt is a common by-product of large-scale bank failure, and large-scale bank failure is a common by-product of government debt default.

This circular relationship has different implications for crisis management, distribution and regulation, depending



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on whether the insuring and borrowing governments are one and the same. When they are the same, as when a government defaults on domestic banks, the allocation of losses and the attendant politics are also domestic: bank failure freezes credit to the economy, depressing growth and tax revenue prospects, and triggering demands to recapitalize banks and compensate depositors. On the other hand, when a government stops paying foreign financial institutions, the distribution of losses from default may turn into diplo-

matic controversy between the borrowing government and the governments that regulate and insure its creditors.

This topic maps this relationship and explores the policy challenges that arise from it. Section I sets out the structure of interdependence between governments and financial institutions, using recent crises in Iceland and Argentina as examples. Section II considers the implications of this relationship for domestic and international crisis response, using as examples the U.S. and UK response to the Third World government debt crisis in the 1980s, and the U.S. government's rescue of the American International Group (AIG) in 2008. Section III examines selected aspects of the government debt crisis in the euro zone (countries using the euro as common currency), and the structure and motives behind the regional response. The conclusion revisits key policy initiatives that promise directly or indirectly to disentangle bank and government financial distress, including cross-border financial resolution and sovereign bankruptcy regimes. ■

## How governments and banks bail each other out

**T**HE NOW-NOTORIOUS “bailouts” of 2008—infusions of U.S. government funds in firms ranging from Bear Stearns and AIG, to Citigroup and Goldman Sachs, and similar responses in Britain and continental Europe—follow from the structural position of financial institutions in national and global economies. Among other tasks, financial institutions mobilize popular savings to supply credit and liquidity for productive enterprise; they also operate payments systems and transmit monetary policy, expanding and contracting credit to the economy at central bank prompting. Where a set of functions—such as intermediation between savers and spenders, liquidity, payments and policy transmission—is an essential public good, then the set of institutions that perform them is essential. The only

open question is whether any particular institution in the set is indispensable. Indeed, the focus of postcrisis reform in the U.S., Europe and the broader Group of Twenty (G-20, representatives of 20 top industrialized and developing economies) has been on ensuring the continuity of such public functions without necessarily insuring particular private institutions.

The essential functions performed by banks, and more recently by a broader range of financial firms, create special vulnerabilities and justify government regulation. For example, because banks have traditionally held popular savings and provided transaction services, the bulk of their liabilities (deposits) have been very short-term, even though their assets (loans) were long-term. This structural maturity mismatch makes

banks vulnerable to deposit runs, where even institutions that made perfectly sound loans cannot meet the nervous public's demand for immediate withdrawals. Structural mismatches and run pressures remain central to banks and their regulation, even as banks and similar institutions have shifted away from retail deposits to raise money in the wholesale financial markets. Moreover, to operate an effective credit and payments infrastructure, financial institutions must be interconnected. As a result, the failure of one institution can spread quickly throughout the financial sector and the broader economy. To address these vulnerabilities, a regulatory regime generally includes deposit insurance; a supply of emergency liquidity from the central bank; prudential rules to limit and cushion risk taking by

insured firms; and increasingly after the latest crisis, a special resolution regime geared to preserving public functions while safeguarding public funds.

The first two features—deposit insurance and emergency liquidity (or “lender of last resort”)—effectively make bank failure a contingent liability of the government. Insolvency of deposit-taking firms depletes the insurance fund and may trigger a call on the government to make depositors whole. When a crisis engulfs many institutions, the government may step in with blanket guarantees of deposits or a broader set of liabilities—it may offer to buy bad assets and/or agree to recapitalize distressed financial firms. Similarly, where a central bank extends emergency loans to firms that later fail, it may not recover its money.

Both forms of public backing create incentives for financial firms and their creditors to take risks in the knowledge that the gains will be private, while the losses are socialized. Prudential oversight and special resolution regimes seek to make up for the perverse incentives potentially created by deposit insurance and the lender of last resort. In particular, prudential regulation typically requires institutions to keep capital against risky assets, and prohibits activities and affiliations that present potential conflicts, while resolution regimes vest public authorities with extraordinary receivership powers.

Yet governments are ill-placed to insure and limit an important kind of risk taking by financial institutions: the risk of extending credit to the public sector. According to the Bank for International Settlements, in March 2010, reporting banks’ exposure to foreign government debt stood at nearly \$5 trillion (the same reporting banks had just over \$6 trillion in exposures to other banks and just over \$14 trillion to nonbank private firms). According to the Federal Reserve, commercial banks in the U.S. hold about \$550 billion in U.S. Treasury securities, up from about \$350 billion in mid-2009, and up dramatically from precrisis levels. These levels are impressive considering the fact that government debt typically



*U.S. Treasury Secretary Timothy Geithner (l.), and Ben Bernanke, chairman of the Federal Reserve, testified before a congressional hearing on Capitol Hill, March 24, 2009. They defended the Obama Administration’s rescue of AIG and asked for expanded federal regulatory powers to seize nonbank financial companies. Signs in protest of the huge bonuses paid to AIG executives are held up in the rear of the room. (DOUG MILLS—THE NEW YORK TIMES/REDUX)*

carries a lower return than the debt of private issuers from the same jurisdiction. And although credit to the private sector tends to be a multiple of credit to the government in normal times, financial institutions either flee—or are prodded—to government debt in a financial crisis.

Even apart from special regulatory incentives for institutions to hold government debt, such debt presents unique attractions, along with unique risks. Governments borrow on a large scale, typically ensuring that their debt is more liquid than that of their nationals. Governments have special sources of revenue (taxation), a subset of captive creditors (state employees and other beneficiaries), capacity to print money and distinct reputational constraints (including security and diplomacy), all of which can be a source of flexibility and motivation to enhance the prospects of repayment—or a source of political pressure that diminishes such prospects. Sovereign governments still enjoy important immunities from debt enforcement, which has led commentators to question the strength of sovereign repayment commitments. On the other hand, unlike private market actors, governments exercise considerable control over the legal environment in which they operate, including mat-

ters critical to debt repayment, such as transfer restrictions and other controls on capital movements.

In addition to these characteristics, most of which follow from their sovereignty, governments as regulators create incentives for financial institutions to hold their debts. For example, internationally agreed bank capital adequacy standards, promulgated by the Basel Committee on Banking Supervision (established by central-bank governors of the Group of 10 in 1974) and adopted by most national financial regulators around the world, have historically treated a significant proportion of government and government-guaranteed debt as risk-free.\* This means that a regulated financial institution wishing to lend to a private firm might have to set aside capital at 8% or more of the loan amount, while it would have to hold no capital for the same loan made to its government. This makes lending to the government cheaper than lending to private firms.

\* *The so-called Basel I capital adequacy framework allowed banks to set aside no capital against credit to governments and central banks of member states of the Organization for Economic Co-operation and Development, which includes wealthy states in Europe, North America and Asia and major emerging economies such as Mexico and Poland.*



The risk-free treatment of government debt is not limited to a bank's own government or to governments with sterling credit. Under more recent iterations of the Basel capital adequacy standard, governments with less than perfect scores from private credit-rating agencies such as Moody's or Duff & Phelps retain the option of letting their own regulated institutions treat their local-currency debt as risk-free. Other governments in turn have the option of deferring to the first government's regulatory treatment of its debt. This can create a measure of diplomatic awkwardness, in effect requiring one sovereign to call another a bad credit, or let its banks engage in regulatory arbitrage (e.g., investing in riskier, higher-yielding assets at no added regulatory cost).

This guideline has particularly interesting implications in the euro zone: Because the euro is the domestic currency of Greece and Germany alike, the Basel II framework allows regulators to treat euro-denominated debts of both governments as risk-free despite the different credit quality of the two governments. Moreover and quite apart from the Basel standards—which become law only when voluntarily implemented by national authorities—all

governments retain ultimate discretion over how domestic regulated institutions treat their regulators' debts. Financially pressed governments rarely shy away from using this discretion.

The combination of inherent and regulatory incentives to finance governments makes it possible for governments to treat financial institutions as their piggy banks, especially in crisis, when no one else would lend to them. On the flip side, this makes regulated institutions uniquely vulnerable to government debt distress. Taken to the extreme, this relationship may produce a continuing cycle of bank and sovereign crises, as governments bail out banks, then come under financial stress themselves, bringing banks down with them.

In sum, financial institutions perform special public functions that motivate governments to insure them and their creditors from failure—especially when failure has widespread economic effects—and to regulate them in exchange for such insurance. Regulated financial institutions are attractive sources of credit for governments, both because they represent large, concentrated pools of savings and because governments, by regulation or decree, can affect the availability and terms of credit. The following two examples

illustrate how backing financial institutions can bring down a government, and how government debt default can imperil the financial system.

### Iceland's banks bring down its government

Between 2003 and 2007, Iceland—a country with about 300,000 inhabitants and an economy of about \$12 billion—transformed from a fishing economy into a major international financial center. It had five main commercial banks, of which the three largest (accounting for 90% of the banking system) were able to borrow tens of billions of dollars short-term on the international capital markets and invest in corporate and real estate assets, many of them speculative and illiquid, mostly located abroad. In 2004–2006, these banks sought to diversify their funding sources and expand their retail deposit base. Buoyed by permissive cross-border expansion rules in the European Economic Area (composed of 27 European Union [EU] members plus Iceland, Norway and Liechtenstein), they attracted deposits from a wide range of sources, including local governments in Britain and retirees in the Netherlands; however, the bulk of Icelandic bank funding still came from the wholesale capital markets. According to the International Monetary Fund (IMF, 187-member institution that monitors the global economy), bank assets grew from roughly equal to nine times the size of the economy in just three years. More than half were abroad, but even assets in Iceland were nearly four times the size of the economy on the eve of the crisis. Over 80% of bank liabilities and just under 80% of their assets were denominated in foreign currencies.

With the global market collapse in the fall of 2008, Iceland's banks could no longer refinance their debts and were shut down by the government in quick succession beginning October 6. Fearing losses to UK depositors, the UK government famously invoked antiterrorism legislation to freeze Icelandic bank assets in the UK, accelerating Icelandic bank failures. Iceland's gov-



*Several thousand people demonstrated in central Reykjavik, Iceland, November 29, 2008, in what became weekly protests over the handling of Iceland's deep financial crisis. The Icelandic government began to close banks in October 2008, and the crisis was compounded when Britain took the unusual step of freezing Icelandic bank assets in the UK. (HALLDOR KOLBEINS—AFP/GETTY IMAGES)*

ernment fell shortly thereafter, and a political crisis ensued that continues to reverberate two years later.

Although some policymakers and observers had commented on the fragility of Iceland's banking model before it fell, in retrospect, the fall looks inevitable: no government can guarantee liabilities even remotely approaching nine times the size of its economy, and no central bank can hold enough foreign currency to serve as a credible backstop against the rush of external claims on Icelandic banks. Nevertheless, the UK and Dutch governments, who paid their nationals for losses incurred in Icelandic banks, have insisted that Iceland's government now owes them compensation, a sovereign liability. Politically, Iceland's banking crisis has upset relations with Europe. The continuing dispute does not help Iceland's efforts to join the EU, while Icelanders themselves are also re-evaluating the benefits of membership.

To be sure, there are few examples of small, open economies whose financial sector explodes overnight as far past its government's ability to regulate and insure it as Iceland's did. But in other ways, Iceland is hardly unusual: faced with a glut of cheap foreign funding owing to national and global macroeconomic factors—such as major exporting states' drive to send savings abroad—financial institutions try to make money in an environment where most investments look safe and currency risk looks remote. When the bubble bursts, a wide range of constituents turns to the government for compensation. The government then engages in complex political horse-trading to distribute losses among local and foreign residents, as well as future generations of citizens now saddled with a huge debt burden, thanks to the misadventures of their ancestors' banks.

### Argentina brings down its financial system

Shortly before Christmas in 2001, the government of Argentina presided over the largest sovereign bond default in history, followed by currency devaluation. Its creditors included foreign individuals and institutions, as well as domestic banks and pension funds. The



*When Argentina's currency and debt default crises hit in 2001 the government took the drastic step of closing individual savings accounts, leaving civilians with no access to their funds. A group of protesters, one armed with a hammer, try to break down a metal wall at a bank in Buenos Aires, February 18, 2002. (ALI BURAFI—AFP/GETTY IMAGES)*

story of Argentina's tumultuous relationship with its foreign bondholders is well-known: after defaulting on over \$80 billion in debt, the government spent years in an intermittent shouting match with Italian retirees, German banks and offshore hedge funds, most of whom ultimately exchanged their debts for new government obligations worth a fraction of the original face value. Holdout litigation continues to this day, and shows no sign of abating. The story of Argentina's complex bargaining with its domestic financial sector is less well-known, but no less instructive.

As private foreign capital markets closed to Argentina's government, it turned to multilateral lenders, such as the IMF, and domestic regulated institutions. Measures to implement this strategy included informal pressure on financial institutions to buy government debt, but also formal but indirect moves, such as effectively lifting the caps on government debt holdings by private pension funds. Between 1998 and 2001, credit to the public sector extended by Argentine financial institutions more than doubled, while credit to the private sector shrank dramatically.

In November 2001, a month before

it defaulted on its foreign creditors, Argentina sought to split its foreign and domestic creditors by transforming their bonds into different obligations. Domestic banks and pension funds were targeted in a debt exchange out of foreign-law, foreign-currency government bonds into longer-term Argentine-law, dollar-denominated bonds that carried a lower interest rate. Although these new bonds survived the foreign debt default, a package of emergency measures passed in early 2002 converted them into devalued pesos, further reducing their value. When the private pension funds protested the currency conversion, they were reinstated in the now-defaulted foreign bonds, triggering more losses.

In response to the crisis, the government also converted banks' U.S. dollar assets and liabilities into pesos at different rates: private sector loans were converted at a 1:1 ratio; deposit liabilities received 1.4 Argentinean pesos for each dollar. Depositors effectively got a 40% subsidy at the expense of the banks. When bankers threatened to walk away from their banks and shut down the financial system, the government compensated them with new dollar-denominated domestic-law government debt

that yielded a low interest rate, but continued to perform all the while foreign bonds remained in default.

Like the preceding example of Iceland, this study of Argentina is unusually stark: the government effectively raided the private financial sector on multiple occasions, using informal pressure, regulations and fiscal subsidies to get financing for itself. These tactics threatened to bring down the financial system; however, ultimately the

government managed to maintain the system's core public functions. Domestic financial institutions continued to grow in importance to the government as Argentina remained cut off from global markets as a consequence of its contentious default and restructuring.

And as with the story of Iceland's crisis, the story of Argentina is a graphic illustration of a phenomenon present in more muted tones in many, if not most, economies. Governments facing debt

distress foster and take advantage of "financial patriotism" on the part of their regulated institutions. This strategy often comes at a time when financial institutions are already vulnerable: the broader economy is in decline, private borrowers are having trouble repaying their loans and capital cushions are depleted. If the government defaults, it may threaten the survival of the private financial sector and the broader domestic economy. ■

## Distributing bank and government losses across borders

**T**HE INSIGHT that large-scale failure of financial institutions falls on governments, and government debt default falls on regulated financial institutions, prompts a special set of policy concerns when the key actors come from different countries. Although the examples from Iceland and Argentina focused on the relationship between governments and their subjects (domestic banks and pension funds), losses from those crises also fell on foreign governments, foreign institutions and individuals. Where governments can control the distribution of losses through regulation, sub-

sidies, and selective default, they may externalize them beyond their borders, effectively off-loading them onto other governments. It is not surprising then that financial crises, especially crises in integrated, open economies, can easily provoke diplomatic tensions—and it is not uncommon for governments to argue over crisis management strategies as a proxy for how to allocate losses.

Two stylized scenarios illustrate the challenge. First, where banks in one country lent large amounts to a foreign government that proceeds to default, the banks' assets would deteriorate,

which may threaten their capacity to repay depositors. The creditors' government then must choose among letting its banks fail and compensating depositors; bailing out the banks; or pressuring the defaulting government to pay up. The borrowing government in turn has the choice between stiffing all its creditors equally, selective default or differential compensation (both of which ultimately involve paying some creditors over others). It may discriminate openly and formally, or covertly, defaulting on everyone while compensating some creditors under the table.

When the defaulting government's creditors are domestic banks, it comes under immense political pressure to protect domestic depositors, who vote. Whether it does so by bailing out the banks, letting banks fail and paying deposit insurance, or not defaulting in the first place, is largely a matter of spill-over and transaction costs. In contrast, when the creditors are foreign, the borrowing government may avoid some core costs altogether: it does not much care about foreign depositors in foreign creditor banks, and is only too happy for the foreign government to pick up the tab to mollify foreign voters. The political pressure to pay shifts to diplomatic and intergovernmental channels.

The second illustration is a varia-



H. L. SCHWARDRON





*The subject of loss distribution is complex, and particularly nuanced solutions often arise when dealing with cross-border distribution. Investment experts from around the world met in Kuwait City on April 5, 2009, to chart future investment plans and review developments in the global economy at the fourth meeting of the International Working Group of Sovereign Wealth Funds. (YASSER AL-ZAYYAT—AFP/GETTY IMAGES)*

tion on the theme, replacing a borrowing government with borrowing banks. Where banks in one country owe large sums of money to banks in another, the debtors' distress may become a problem for both governments. The debtors' government would face the many rippling domestic consequences of bank failure, such as the collapse of credit and payments systems. On the other hand, foreign creditor banks will see their assets deteriorate, perhaps threatening their own capacity to pay depositors. Here again the creditors' government will be called upon to bail them out or compensate depositors in the event of their failure, all because of problems abroad. But instead of bailing out creditor banks, the creditors' government might pressure its counterpart to bail out the debtors—shifting losses onto taxpayers in the debtors' country.

The argument for a debtors' bailout may sound especially compelling when distress is due to broad economic and policy factors, such as a burst credit bubble or a currency crisis, rather than individual borrower flaws, which creditors should be able to discover and mitigate. But it is precisely in such a crisis that the debtors' government is facing the largest number of competing demands from constituents, while its capacity is most strained. As with the first example, any losses pushed onto foreign creditors or their governments would thus free

up resources for domestic distribution.

These stylized illustrations are simplistic, most importantly because even in a major crisis the typical policy choice is much more nuanced than full bailout versus total collapse; and full bailout is hardly ever the outcome. The earlier examples of Iceland and Argentina already show that loss distribution is negotiated in waves, over time, among multiple constituents. However, the choice between domestic and cross-border loss distribution is especially stark, with radically different political implications. The following two case studies elaborate the complex challenge of distributing losses from crises across national borders.

### Distributing losses from Third World debt crises

What came to be known as the Third World debt crisis of the 1980s inspired an enormous literature, including seminal theoretical contributions to the understanding of sovereign debt. The same series of events could have—but did not—become the “First World Banking Crisis” to rival the Great Depression of the 1930s.

Between August 1982 and October 1983, 27 governments from Latin America, Africa, Asia and Eastern Europe suspended payments and initiated rescheduling talks over their obligations to commercial banks in the U.S.,

the UK and Germany, among others. In 1982, when Mexico initiated the wave of suspensions and restructurings, loans to the 17 most heavily indebted governments represented over 130% of all capital in U.S. banks, 85% of all capital in British banks and over 31% of all capital in German banks. The nine largest U.S. banks were exposed to the tune of 194% of their capital; over 44% for Mexico alone.

Like the latest round of debt distress, the sovereign loans of the 1980s originated in a credit bubble: the influx of dollar deposits in major financial centers, which followed the 1970s oil price shocks and the resulting spikes in dollar revenues of energy-exporting countries. In looking for new markets, banks promptly recycled these petrodollars in high-yielding loans to developing countries, where governments borrowed for their own account, but also ultimately assumed the debts of their private-sector borrowers. In the early 1980s, a global recession and rising interest rates in the U.S. made it impossible for developing-country governments to refinance their dollar debts. At the same time, banks in major financial centers were under stress, their capital worn thin with recession, and their loan-loss provisions nowhere near levels that could absorb the looming defaults.

Sovereign debtors and their creditors' governments faced a dilemma:



if they proceeded with default or reduction of principal, major banks in wealthy countries would have been exposed overnight as insolvent, potentially triggering deposit runs and widespread economic dislocation in creditors' countries. On the other hand, creditors' governments could have bailed out their banks to prevent this outcome. In the event, a negotiated arrangement was reached with each debtor, whereby a bank syndicate agreed to refinance the debts in the hope that distress was only a temporary liquidity problem; the debtors also received financing from multilateral creditors and promised policy reform. Such arrangements did not hold for long and had to be renegotiated frequently, with the result that borrowing governments accumulated more and more debts: foreign bank claims on the most heavily indebted countries went up by nearly one third between 1982 and 1987, while economic growth stagnated. But over the same period, banks in New York, London and Frankfurt were rebuilding capital and provisions, so that by the late 1980s, their total exposure to developing countries was a much smaller portion of their capital.

The tide turned in 1989, when the idea that developing-country debt

stocks were unsustainable became actionable and politically acceptable: banks could absorb principal write-downs with relatively modest regulatory forbearance. In March of that year, U.S. Treasury Secretary Nicholas F. Brady gave a famous speech where he recognized publicly for the first time that full debt repayment would stunt growth in these debtor countries; this signaled major policy change on loss allocation. His initiative produced a series of debt relief and restructuring agreements with substantial principal reductions, led again by Mexico, including the forgiveness in total of some \$60 billion in debt, much of which fell on banks and their shareholders. However, debt relief was conditioned on dramatic economic reforms on the part of the borrowers, which brought about large-scale privatization and liberalization in many developing countries.

To be sure, the delay in principal reductions and the resulting long-term costs for debtors' economies was a function of many complex factors. However, there is little doubt that the health of leading international commercial banks was a key factor in treating the crisis as one of temporary borrower illiquidity. The initial loss allocation, which put the burden of debt distress primarily on the debtors in the form of higher debt stocks and domestic economic adjustment, was the product of a high-stakes political and diplomatic negotiation similar to those that take place in other financial crises.

### Distributing losses from AIG derivatives contracts

The U.S. government's rescue of AIG, the trillion-dollar global insurance conglomerate, remains among the most dramatic episodes at the height of the financial crisis in the fall of 2008. On September 16, 2008, as U.S. and global markets reeled from Lehman Brothers' bankruptcy filing, the Federal Reserve extended an \$85 billion credit line to AIG, using emergency authority under Section 13(3) of the Federal Reserve Act. The U.S. government also effectively took 79.9% ownership of the company. This package was restructured and aug-

mented at least three more times, including with funds from the U.S. Treasury's Troubled Asset Relief Program (TARP) authorized by Congress. The ultimate size of U.S. public sector commitments to AIG peaked at \$182.5 billion.

Even though AIG had stood at the center of a sprawling global web of complex and risky financial positions far removed from traditional insurance activities—including \$441 billion in unregulated derivative contracts—its unraveling caught U.S. authorities by surprise. AIG's precarious condition came to light at the same time as Treasury and the Federal Reserve were dealing with the better predicted, but no less daunting troubles at Lehman, Merrill Lynch and Citigroup, among others. Much of the insurer's distress originated with its subsidiary, AIG Financial Products, which wrote hundreds of billions of dollars in derivative contracts (credit default swaps) that promised, in exchange for a fee, to pay counterparties for losses on a wide range of financial instruments, including mortgage-backed securities. If the underlying instruments deteriorated in value, or AIG's own credit rating declined, it was bound to post new collateral. Escalating collateral calls over the course of 2008 brought AIG to the brink of collapse. The U.S. authorities cited AIG's links with vital parts of the U.S. financial sector, notably money market funds and retirement savings vehicles, as well as the potential impact of AIG's failure on domestic and global market confidence in dire times, as grounds for the rescue. However, transnational regulatory dynamics also played a key role in shaping the outcome.

Faced with the continuing drain of collateral calls under AIG's contracts despite its \$85 billion credit line, the Federal Reserve tried to terminate them in November 2008; however, the counterparties demanded full payment in exchange for termination. Ten out of AIG's 16 major counterparties—including the largest, Société Générale (SocGén)—were European financial institutions. Some of them had bought protection from AIG with the express purpose of reducing their regulatory



*The offices of insurance giant American International Group (AIG) are reflected in a nighttime view of New York City, February 24, 2009. Since the collapse of the company in the fall of 2008 its bailout has cost U.S. taxpayers \$182 billion. (MARIO TAMA—GETTY IMAGES)*

capital requirements for holding risky assets; in retrospect it turns out that they and their supervisors exchanged credit risk for counterparty risk. Federal Reserve officials attempted unsuccessfully to extract concessions out of AIG's counterparties in the U.S. and abroad. Because AIG had a number of contracts with French banks, the U.S. authorities reached out to the Commission Bancaire, the French bank regulator, in an attempt to reduce potential exposure to the U.S. taxpayer and achieve a modicum of cross-border loss distribution. However, the U.S. government was unwilling to risk the domestic consequences of an AIG bankruptcy and had effectively shown it by putting \$85 billion on the table in September. The French authorities and their banks called the U.S. bluff. Without cross-border burden sharing, AIG's counterparties and their governments effectively escaped the respective consequences of their credit judgments and supervision, while the U.S. potentially bore a disproportionate cost of preventing a global financial meltdown.

AIG's counterparties ultimately received over \$62 billion in full compensation to terminate their derivative contracts. Beyond direct U.S. government payments to European institutions, Goldman Sachs—the second-largest beneficiary of U.S. government payments to AIG after SocGén—effectively paid over its share almost entirely to its own European counterparties. The fact that AIG did not default also indirectly benefited firms that sold Goldman Sachs protection on AIG. European institutions, mostly banks, represented over 40% of the last group by number and exposure amount.

The lessons of AIG are complex, and many aspects of the case have been mined in academic and oversight reports. Its role here is distinct: to illustrate the foreign policy dimension of financial crisis response, which can be obscured because of its location in informal, technocratic regulatory coordination channels. Foreign policy concerns are salient even where no direct sovereign debt is involved in the first instance, where the firm and its global network of affiliates stay out of bank-

ruptcy, and where the ultimate “bailout” looks domestic, as with the U.S. government's support for AIG. Managing the debts of a large financial institution active across national borders almost inevitably requires some negotiation among politi-

cal authorities over how the losses will be apportioned. This is so in part because the linkages among cross-border financial firms can effectively transmit distress to the firms' respective governments, which guarantee them. ■

## Regional variations: the crisis in Europe



*Revelations over the size of Greek public debt at the end of 2009 and the fear that Greece would go into default threatened the stability of the euro zone and forced it to take drastic austerity measures. Greek protesters clashed with police in Athens, May 5, 2010, as unions of public and private sector employees called a 24-hour nationwide general strike. (GIORGOS MOUTAFIS—ANZENBERGER/REDUX)*

**D**OMESTIC and cross-border links between banks and governments present special challenges in the context of regional integration. The 2010 crisis in the euro zone illustrates the way in which such links can reveal gaps in the institutional fabric of integration, test political commitment to the project and force the development of new institutional solutions.

Speculating about the survival of the euro has been fashionable ever since, in late 2009, the Greek government admitted its past estimates of its budget and debt statistics were inaccurate, as part of an attempt to hide its failure to meet EU treaty commitments to 3% budget deficit and government debt at 60% of gross domestic product (GDP). On the

one hand, this was nothing new: most major European governments have breached these commitments at one time or another since their adoption in 1991, and officials in the EU Brussels headquarters had long been skeptical about Greek numbers. However, in a market barely recovered from the shock of 2008, Greek reality turned out to be so wide of the treaty mark—12.7% budget deficit and debt on track to pass 117% of GDP—that it served as a tipping point, undermining market confidence and raising doubts about Greece's capacity to refinance maturing debt on the order of \$25 billion to \$30 billion in the first half of 2010. Commentators soon started coalescing around the idea that Greek debt was unsustainable as a

proportion of GDP, on a par with some of the poorest countries in the world that qualify for bilateral and multilateral debt relief.

Assuming Greece has a solvency problem (a proposition fiercely debated in some quarters, including Brussels and the IMF), restructuring its debt would likely shake confidence in the European project, the euro itself and have repercussions throughout and beyond Europe. As initial revelation snowballed, investors and policymakers began to focus on other member states whose public or private sector debt appeared to strain their capacity to pay, such as Portugal, Ireland and Spain, and occasionally Italy; as a result, the costs of borrowing shot up on the European periphery.

However, Greek debt has intriguing institutional features that create incentives for restructuring, even as it has others that serve as obstacles. Of the \$390 billion in debt that Greece owed as of September 2009, over 70% was held by foreign creditors, with French banks and insurance companies and German banks in the lead, holding a combined \$90 billion. Greek banks and pension funds were only slightly ahead at \$93 billion. History suggests that restructuring debts owed to foreign creditors may create a limited opportunity to externalize losses, unlike default

on domestic banks, which may simply exchange one claim on the government (by banks) for another (by depositors and pensioners), with the attendant costs of financial sector disruptions. Yet because most of Greece's foreign creditors are regulated financial institutions in the EU, the politics of pushing Greek losses onto them is daunting.

Second, unlike most international sovereign borrowers, over 90% of Greek debt contracts are governed by Greek law, and most have provisions that lend themselves rather readily to modification. This means that, at least in theory, Greece can credibly threaten to restructure its debt by fiat—passing a domestic law—although it may face some lawsuits at home and in the European Court of Human Rights (the 47-member supranational human rights recourse court). But here, too, Greece runs into the obstacle of seeking solvency at the expense of thinly capitalized and still-stressed European financial firms, and by implication, other member governments.

European crisis managers in the winter and spring of 2010 were well aware of the fact that Greek debt problems were also their own financial sector problems, much like Mexico's debt problems were U.S. banking problems in 1982. And evoking the U.S. response to the Third World debt crisis in 1982,

the EU opted to mobilize loans to re-finance Greek debt, with a three-year, 110 billion-euro joint EU-IMF package tied to a strict IMF policy program. In addition, the EU launched a 440-billion-euro European Financial Stability Facility (EFSF), activated in August for three years and financed by member states and market borrowing, with the principal purpose of fortifying the European periphery and arresting financial contagion from Greek distress. The IMF complemented with a 250 billion-euro facility of its own, the European Commission chipped in with another 60 billion, and the European Central Bank ramped up purchases of member states' debt to supply market liquidity.

If all goes according to plan, Greece will undergo dramatic adjustment, which will be painful, but will allow it to avoid default, at least for the first three years of the program. But two other side effects are likely: First, as is happening already, foreign creditors will drift away from Greek debt auctions, and will be replaced in the first instance by Greek regulated institutions. Second, if Greece is unable to raise cash even in the domestic markets, its creditor base will shift to other governments and multilaterals. The political implications of these alternatives are significant if the government experiences further debt distress: instead of stiffing foreign banks, a government wishing to restructure would have to negotiate with its own voters, already feeling the effects of austerity programs, foreign governments and multilaterals.

In the fall of 2010, European policymakers agreed to consider a standing successor to the EFSF, including the conditional funding mechanism. However, they were also searching for longer-term solutions to complement a bailout mechanism, including ways to ensure an orderly debt restructuring and to "bail in" private creditors. This is a step toward greater integration, and a more formalized, politically sanctioned and institutionally robust loss distribution process within the EU.

In sum, the euro-zone crisis of 2010 presents perhaps the most complex permutation of the concerns at the center



*In the wake of a two-year financial crisis, Brian Cowen, Ireland's prime minister (l.), with his finance minister, Brian Lenihan at his side, announced at a press conference in Dublin, November 21, 2010, that he had asked the European Union for assistance. Individual EU governments, the IMF and two EU emergency funds provided a complex \$112 billion rescue agreement for the country's banks. (AIDAN CRAWLEY—BLOOMBERG/GETTY IMAGES)*



of this topic: a tight web of cross-border bank and sovereign liabilities that frames the political imperatives of those engaged in crisis response at the national level. The regional integration context is both a source of constraints and a platform for institutional innovation that might not be possible either on a global scale, or elsewhere in the absence of threshold political commitment.

### Potential solutions

The crisis has brought calls for law reform to ensure more orderly resolution of bank and government financial distress: first, a cross-border regime for supervising and, if need be, resolving global financial conglomerates (parallel to bankruptcy for nonfinancial firms) and second, a revival of proposals for a treaty-based sovereign bankruptcy regime, focused on Europe.

Both sets of proposals have some merit; however, this topic intimates that neither set can succeed without fully accounting for the other. Thus a regime—even one robustly enshrined in a treaty—which requires national governments to absorb the losses of foreign financial institutions at the expense of its own citizens may well be a political nonstarter. Conversely, if a bank has no capital to cushion the losses from a sovereign restructuring, no amount of orderly process can overcome this. When the institutions are backed by governments, incentives to participate in the process may be weak.

Financial crises are routinely described as exceptional, transformative events that illuminate past policy and regulatory failings and open a path to redemption through law reform. In the U.S., the long crisis—or series of crises—that began in 2007 produced the Dodd-Frank financial reform act, which seeks to expand the scope of regulated institutions, markets and activities, and to make it harder for the Federal Reserve and other financial regulators to bail out insolvent financial firms. In Europe, the crisis has produced important changes in the structure of regulation, including further centralization of authority and efforts to systematize the resolution of financial conglomerates. It



*The euro symbol is illuminated in front of the European Central Bank (ECB) in downtown Frankfurt, Germany, December 2001. The euro is the official currency of the euro zone and is shared by 16 EU countries. It is now the second most traded currency in the world after the dollar. (BERND KAMMERER—AP)*

may yet lead to a shift in the economic structure of the union itself, closer fiscal ties among member states and even a sovereign debt restructuring mechanism. However, the will and direction of such reforms is driven by events. As Ireland's banks and government finances narrowly escaped collapse thanks to another EU-IMF package in November, the sentiment in Europe seemed to move away from experimenting with treaty-based sovereign bankruptcy and to more case-by-case restructuring.

At the international level, the crisis has elevated the G-20, the IMF and the Financial Stability Board (a network of standard setters), and prompted expansive efforts to coordinate both regulatory and economic policy among the world's leading economies. It has brought about yet another revision of the Basel capital accords, geared to raising the level and quality of capital in financial institutions, especially those whose failure would threaten the broader financial system.

Postcrisis reforms everywhere appear to have in common an expansive view of the regulated financial system, and a need to answer popular demands for burden sharing with mandates to make market participants bear losses, instead of shifting them onto taxpayers.

But no statute or contract can conjure up resources adequate to absorb the shifted burden. As a result, governments that seek to allocate losses to private market participants may simply find themselves negotiating with other governments that regulate and stand behind the private players. Similarly, private firms that draw on government support may find themselves (as Irish banks did in late 2010) sinking along with the government that had lost credibility from bailing out the banks.

There are two ways of avoiding such feedback loops: first, building barriers within the system to reduce the speed and magnitude of loss transfer, and second, ensuring that all parts of the system have the capacity to monitor and absorb potential losses. Barriers run counter to the globalization impulse, while boosting cushions against loss can make credit more expensive, and finance smaller. This calls for a very different financial system, and a very different relationship between governments and financial institutions than what prevails today in the U.S., Europe and much of the rest of the world. ■



**Opinion Ballots  
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## discussion questions

1. This topic has underscored the interdependence of banks and governments as a given feature of the U.S. and European economic landscape. Should policymakers strive to eliminate or reduce the interdependence of banks and governments? Do you think this is possible, and if so, is there a credible way of achieving this goal?
2. If the banking system of a country failed, and those banks held significant amounts of foreign deposits (e.g., Iceland in 2007), what would you consider a fair allocation of those losses? From your perspective, should more of the liability fall upon the bank's shareholders and home government or upon the foreign depositors and their governments?
3. Do you think it makes sense to have a mechanism or framework for dealing with governments when they go

bankrupt and default on their debts? What would be needed to convince indebted states to use it? And how should a sovereign bankruptcy mechanism be structured to also maximize incentives for financial institutions to participate?

4. Should regulators impose limits or penalties on bank holdings of government debt? Should there be a set standard for how to evaluate and apply government debt risk? If yes, should such penalties or limits apply both to domestic and international firms? Should they apply differentially?
5. In the case of Iceland, consider how its banking sector collapse might have played out if it were a member of the euro zone. Do you think the European Union would have responded to the problems of Iceland as it did to Greece's public debt difficulties?

## suggested readings

Bulstein, Paul, **The Chastening: Inside The Crisis That Rocked The Global Financial System And Humbled The IMF**. New York, PublicAffairs, 2003. 448 pp. \$21.00 (paper). This accessible narrative from *Washington Post* reporter Blustein includes illuminating interviews with International Monetary Fund insiders and offers a revealing look at the IMF's successes and failures in handling international financial crises.

Financial Services Authority, **The Turner Review: A Regulatory Response to the Global Banking Crisis**. March 2009. 126 pp. Available free online at: <[www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf)>. This report, commissioned by the British chancellor of the exchequer and named after the chairman of the Financial Services Authority, provides a postmortem of the most recent financial crisis and recommends significant banking reforms at both the national and international levels to ensure future stability.

Kindleberger, Charles P., and Aliber, Robert, **Manias, Panics, and Crashes: A History of Financial Crises**. Hoboken, NJ, John Wiley & Sons, 2005. 336 pp. \$21.95 (paper). Exploring financial bubbles

and money mismanagement, professors Kindleberger and Aliber have updated the fifth edition of their classic study of market crises, originally published in 1978, with a look at several of the most recent major financial crises.

Reinhart, Carmen M., and Rogoff, Kenneth, **This Time is Different: Eight Centuries of Financial Folly**. Princeton, NJ, Princeton University Press, 2009. 496 pp. \$35.00 (hardcover). Economists Reinhart and Rogoff provide a comprehensive retrospective on economic crises throughout history and across the globe. Their analysis of patterns of economic behavior and conditions provides fresh insight into the most recent crisis.

Roubini, Nouriel, and Setser, Brad, **Bailouts or Bail-Ins: Responding to Financial Crises in Emerging Markets**. Washington, D.C., The Institute for International Economics, 2004. 427 pp. \$28.95 (paper). Drawing on their experience in policymaking, these scholars examine the International Monetary Fund's options for assisting emerging market economies and make thoughtful suggestions for reform.

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