Lessons for the Greek crisis from Philip II of Spain

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If you want to go back to the roots of **Greece's financial crisis**, you could always start with Philip II of Spain. Born in 1527; acceded to the Spanish throne in 1556; defaulted on the national debt in 1557, 1560, 1575 and 1596; died in 1598. Now there's a sovereign who knew how to renounce sovereign debt. Philip would leave an Argentine finance minister standing.

The path of default he laid down has seen heavy traffic across the centuries from monarchies and republics, democracies and dictatorships. Europe – and increasingly the world – is now watching the chaos in Greece and wondering if this is a **Lehman Brothers** of the public sector. So it is striking that after all this time the world still treats restructuring, or the rewriting of sovereign debt contracts, as an act of extraordinary calamity.

Despite the sounds of garment-rending catastrophe that generally accompany them, defaults are not at all unusual. Outstanding historical research by Ken Rogoff and Carmen Reinhart, which forms part of their drily titled book *This Time is Different*, shows defaults coming in waves. Some reflect the cost of maintaining armies: there was a flood of defaults during the Napoleonic wars. Others simply reflect a downturn when a sudden stop in capital flows and economic growth makes previously tractable debt burdens unsupportable.

The wave of defaults triggered by the Great Depression extended to the 1950s, when nearly half the countries in the world were in default. Even the US in effect repudiated obligations by legislating forcibly to sever a link between Treasury bonds and the gold price. Greece itself built up a rich history of welching on its debts. Crises starting in 1826 shut it out of capital markets for 53 years; its Depression-era external default lasted from 1932 until 1964.

In 2010, there are widespread sovereign debt problems. They are unusually concentrated in the advanced world. The proximate cause is governments taking on massive private sector debt as part of their financial sector bail-outs. But that came on top of nearly a decade of underlying fiscal deficits in many rich countries, funded by borrowing and often masked by a short-lived surge in tax revenue pumped up by a housing boom and an asset bubble.

So that is how we got here. And there is a big divide between official and private views of how to get out. Most economists and investors think Greece will have to restructure – the fiscal arithmetic is too unpleasant and Greek society too divided to deliver the **cuts needed**. But European finance ministers and the International Monetary Fund insist that is unthinkable.

Public musing about restructuring may indeed incur costs. Yet history suggests that hanging on can make matters worse. On the way to the world's biggest sovereign default in 2001, Argentina managed to extract misconceived **IMF loans** with the implied threat that the fund would be blamed if it pulled the plug. In the meantime, Buenos Aires undertook a bond swap, which bought it a few months' respite at the cost of a rise in the debt burden, worsening the default when it came.

Although there are differences, Greece looks increasingly like Argentina on the Aegean. If Athens does start to draw down large amounts from the **eurozone-IMF rescue loan package**, it could merely throw good (public) resources after bad (private) money. If Greece loads up on IMF and eurozone government debt it will merely push existing creditors further down the pecking order in any **restructuring** without making much difference to the probability of default.

In the case of Greece, it may in fact make sense to delay the inevitable for six months or a year, hoping that the European and global economies will recover and boost Greek exports. The French and German banks that hold much of the Greek debt may be able to prepare for the hit of restructuring. But when the crunch approaches, it is still more likely that big eurozone economies will try to stop Greece defaulting for the sake of pride and their own banks than allowing the country to bow to the inevitable.

Defaults, as Profs Rogoff and Reinhart argue, do not have to be disastrous if they are accompanied by a shift in government policy for the better. As long as restructuring is rapid and equitable, capital markets can be forgiving. Yet most attempts to regularise restructuring have foundered on suspicions that their existence would encourage it. A perfectly sensible idea from the IMF in the early 2000s foundered on opposition from banks and investors.

Choosing when to restructure is not easy, because the distinction is not always clear between a short-term liquidity crisis, which needs rescue lending, and an insolvency that requires restructuring. In fact, the academics Mauricio Drelichman and Hans-Joachim Voth argue that Philip II's first three defaults were liquidity shocks arising from fighting wars. Like Greece, he was backed by German financiers – in his case the legendary Fugger banking family of Augsburg. Unlike Greece, he didn't have the IMF to go to. Yet going into default – even four times in one reign – was not disastrous. The lenders continued to lend.

Any decision to restructure should be taken with reason, not as a panicked last resort. Restructuring sovereign debt is not the end of the world. It wasn't even the end of King Philip's empire.

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