In the case of sovereigns, should official sector debt be subordinated to private sector debt?

YES

The euro crisis forcefully highlights a fundamental problem regarding sovereign debt. After delaying the haircut private creditors had to suffer (despite being labelled voluntary), official lenders enforced preference for their own loans illegally and *ex post*. Creditor losses, if the debtor becomes insolvent, are part and parcel of lending. But illegal and inappropriate official interventions unnecessarily increase these losses, and in tandem with undue preference for such abusive loans, are patently unfair and economically dangerous.

Illegal preference has been an unfortunate routine for decades. The IMF and other multilateral lenders have been able to secure *de facto* preferred creditor treatment, despite not being preferred at all. In fact, their statutes even suggest subordination. In the case of Greece, things are even worse. On top of this multilateral privilege, the EU grafted an *ex post* preference for itself and its members onto the private sector. Before Greece, illegal preference affected only relatively small percentages of all loans (for example, Argentina's debts with the IMF in 2001, even though relatively big at that time).

But the share of official loans in Greece and Europe is massive. The private sector has been forced to pick up the bill for official sector incompetence and failure. The EU established a ladder of preference for official creditors that delay insolvency. This is in stark contrast to many municipal laws, which define this exact behaviour as a crime. Abusive official debts must be subordinated, both for legal reasons (such as equity) and economic reasons (not obstructing credit markets). *Ex post* preference for official lending was, quite correctly, one reason for the downgrading of several euro countries.

In the EU such malpractice is particularly unfair considering the public sector's role in luring private investors into the region's sovereign bonds. Imposing a public sector preference after the crisis broke is particularly nasty. In the case of Greece, private creditors would have been spared a lot of trouble if the public sector – sure to be able to privilege its own claims unduly – had not exacerbated the crisis through abusive lending. Especially in Greece's case, official creditors worsening the situation must not be rewarded financially. Subordinating them is mandatory.

The Greek result was to be expected. After *bona fide* private creditors suffered a substantial (so-called voluntary) haircut under threat and a buy-back programme (Haircut II), Greece continues to be insolvent. Postponing the haircut made things worse for everyone except some bureaucrats and politicians, anointing themselves as troubleshooters.

In a number of jurisdictions, abusive lending that only prolongs crises entitles *bona fide* creditors to compensation. Adapting this concept to sovereign crises, sovereign debt expert JP Bohoslavsky suggests subordinating such loans.

Official sector involvement is now unavoidable, and is sure to come after German elections. This delay will allow politicians to pull the wool over their electorate's eyes. Germany is the last nest of resistance to politicians squandering tax money on the euro crisis. Eager to protect its own illegal preference, the IMF is now pushing for losses by other official creditors to free up money to repay the IMF.

The status of preferred creditor is absent from all International Financial Institution (IFI) statutes. The impression rather successfully nurtured over decades that IFIs are preferred creditors is absolutely unfounded, as can be seen from their own homepages and articles of agreement. IFIs have undone their founders' intention of subordinating IFI claims to foster and reassure private flows. In fact, they have actually done the exact opposite.

The IMF knows that it enjoys no legal or contractual preferred creditor status, as one can read on its very own homepage. Initially its claims were actually subordinated to private claims, but this explicit stipulation was deleted by the second amendment to its statutes. In addition, there is nothing prohibiting IFIs from taking part in legal procedures, either in courts or arbitration. Therefore, IFIs can fully participate in any insolvency proceeding. If (as has happened with Greece and Argentina) official money is lent with the knowledge that these debts can't be repaid, such abusive lending must be subordinated.

Fair burden sharing between private and official sector creditors, and measures against the erosion of private investors' rights and the market mechanism – witnessed in particular in Greece – are mandatory. Fair treatment of private creditors, as well as the comfort of a process supervised by an impartial judge or arbiter is needed. *Ex post* preference in favour of official lenders must go.

Alternatives that do not subordinate private claims must be explored. At the beginning of the Greek crisis, some people in the banking sector proposed a quick haircut – an opinion seconded by investors such as Pimco's chief El-Erian and academics. At that point there were no official debts. The steep increase in Greek debt since then was largely caused by an official bailout in open breach of the EU's no bailout rule.

A quick cut – as proposed early on – would have contained losses. In February 2010, for example, Gros and Mayer (the latter being Deutsche Bank's chief economist at the time) proposed a haircut of 50%. If this had occurred, Greece would have been afloat again, the private sector would have lost less, and no tax money would have been wasted.

Naturally, a proper sovereign insolvency procedure as I have advocated since 1987, would have been preferable. This would have wasted no tax money, and would have reduced both private sector losses and the suffering of the Greek people.

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