Debt default in a developed country is unthinkable – or is it?

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Greece's fiscal travails and ratings downgrades have provided some year-end trades for the speculators who have been betting against the bonds of the least flush euro area governments, and a great deal of material for professionally gloomy commentators such as myself.

Most of the product of the euro-commentariat has stopped short of predicting outrightdefault. That would, it is generally understood, be unthinkable for a developed country. It's the sort of thing done by the Argentines of the world, not Europeans or Americans.

Oh, sorry, strike the last statement. A developed, advanced, government-of-laws-not-men such as that of the*US could* repudiate its debt, and it did so in 1933. In March of that year, the US passed a law effectively repudiating the "gold clause", incorporated in public and private bond documentation, that promised payment in currency equivalent to a fixed mass of gold, or "weight", as non-physicists say.

The private ownership of monetary gold was outlawed, and creditors were instead told that they would be paid in "legal tender coin or currency." The US declared that the gold private citizens could not own was now worth $35 per ounce, rather than $20.67, for an effective devaluation of 41 per cent.

That devaluation was more than twice the post-euro-entry increase in the real effective exchange rate (Reer) of Greece, more than the Reer increase of Spain and Italy, and just a little less than the Reer increase of Hungary over the same period.

Economists, columnists, credit analysts, and the like say that ultimately these countries need to regain that Reer competitiveness with either "internal devaluation", ie wage, pension, and state services cuts, or "external devaluation". The first means that the population pays, the latter that external creditors pay.

The gold clause was not just a press release, or summit communique, but the law of the land. Creditors based their investment decisions on its supposed inviolability. Some of them just cursed and snarled, and some took the US Government to court. Those cases were decided in 1935 by the Supreme Court, in Perry v United States. Perry lost. Or, rather, he won on principle; the court said that the law "went beyond the congressional power." But so what, since "plaintiff's damages could not be assessed without regard for the internal economy of the country at the time."

There are more and more European lawyers and authorities who seem to be taking something more than a purely historical interest in Perry. There is a small community of experts on the law of sovereign immunity, or how and when you can, or can't, enforce claims against a state. Among them is Lee Buchheit, of Cleary Gottlieb in New York. He has represented sovereign defaulters such as Iraq and Argentina, and now seems to be preparing for yet another set of actions. He's also in greater demand as a speaker to professional groups. In Europe.

Back to our question: what would be the practical effects, such as asset seizures, on a euro area issuer of a default on its sovereign debt? By "default", I mean a failure to make timely interest and principal payments, in euros, on euro-denominated debt. Devalued payment in "drachmas" or "new pesetas" is assumed not to work for the creditors.

Mr Buchheit does have some good news. Whatever a national court says, another European court "could hand down a judgment that you have to pay the equivalent of what you owed." And in the US, "The fact that a foreign sovereign has taken action to breach a contract will not relieve courts of handing down an [adverse] judgment."

He also has bad news. "The clarion lesson of the Argentine experience is that very few sovereigns keep significant assets in their own name outside the country, and those assets tend to be clothed with special protection, such as embassies. Even foreign central banks, in most countries, will be regarded as separate entities, and fiscal agents, not obligors." So if euro member Ruritania has billions in gold or forex in its central bank's accounts in London or New York, the courts won't let creditors take it to satisfy a judgment.

Mr Buchheit doesn't believe the more distressed European countries are like Argentina. No, their problems may be worse in some ways. "In Argentina, you didn't see the individual borrowing in foreign currencies as they did in Iceland, or they do in Hungary or the Baltic states."

To go beyond contract law, what about the euro members' Maastricht Treaty commitments to avoid clever "outs" such as exchange controls? In effect, that was what the US did in voiding the gold clause in privately issued bonds. Take a look, I mean a close look, at the Treaty's Article

73 (d) on free capital flows. That commitment “?.?.?.?shall be without prejudice to the right of Member States?.?.?.?to take measures which are justified on the grounds of public policy or public security.” Wonder what that would mean in practice? Maybe we’ll find out.

http://www.ft.com/cms/s/0/09d02798-ecc6-11de-8070-00144feab49a,dwp_uuid=d8e9ac2a-30dc-11da-ac1b-00000e2511c8.html?nclick_check=1