CEPS COMMENTARY
Thinking ahead for Europe

Sovereign Debt vs Foreign Debt in the Eurozone

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The current crisis in the eurozone is known around the world as the 'euro sovereign debt crisis'. But the crisis is really about foreign debt, not sovereign debt.

The importance of foreign debt is well illustrated by the case of Portugal: although the country's public-debt and deficit ratios are broadly similar to those of France, the risk premium on its public debt increased continuously, until it was forced to turn to the European rescue fund. The key problem confronting Portugal is thus not fiscal policy, but the high (foreign) debt of its private sector – its banks and enterprises.

The limited importance of public debt alone is also evident in Italy and Belgium. Both countries have much higher debt-to-GDP ratios than Portugal, but both are paying a much smaller risk premium. The key reason is that they both have very little foreign debt (Belgium is actually running a current-account surplus). Indeed, although Belgium's debt ratio is above the euro area average (at around 100% of GDP), the country still pays a risk premium of less than 100 basis points – despite being without a government for more than a year.

Why are markets focusing on foreign debt? One reason, of course, is that in a crisis, private debt tends to become public debt. Financial markets thus look at the overall indebtedness of a country. But it matters to whom this debt is owed.

The key point is that eurozone states retain their full taxing powers, which yields a simple corollary for a country with high public debt but no external debt: its public debt is held by residents, and the government can always service its debt by some form of lump-sum taxation (say, a wealth tax).

For example, the government of such a country could simply pass a law that forces every holder of a government bond to pay a tax equivalent to 50% of the face value of the bond. The value of public debt would thus be halved, much in the same way as it would be if the government ordered the central bank to double the money supply, which would presumably lead to a doubling of prices.

The nature of the tax needed to pay off public debt might be different if banks held public debt, because in this case the government would have to tax the holders of bank deposits. But the key point remains: as long as a government retains its full taxing powers, it can always service its domestic debt, even without the ability to print money. But this is not the case if the debt is owed to foreigners, because the government cannot tax them.

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It is thus foreign debt that constitutes the underlying problem for a sovereign with solvency issues. (The exception to this rule is the United States, which enjoys what Charles de Gaulle called its “exorbitant privilege” of having its foreign debt denominated in its own currency.)

Things get more complicated if foreign residents hold a large part of a country’s public debt, but its residents also have large foreign assets. In this case, the government faces the temptation to default on its foreign debt, while its citizens can still enjoy the returns from their foreign assets. The more difficult it is for the government to tax its residents’ foreign assets, the greater this temptation will become. Yet, even in this case, the government should be able to service its debt if it can somehow induce its citizens to sell their foreign assets and buy domestic government bonds instead.

The importance of this point was illustrated in 2001 by Argentina, which did not have a large net foreign debt. The private sector had large foreign assets, while the government had about the same amount of foreign liabilities. Even so, Argentina went bankrupt, because wealthy Argentines had spirited their assets out of the country, and thus out of the reach of the government, while poor Argentines refused to pay the taxes needed to satisfy foreign creditors’ claims.

On the other hand, when the foreign assets of the country are held not by households, but by institutions, such as pension funds, they can be identified and taxed. This is mostly the case in Europe.

This analysis suggests that the ‘excessive [current-account] imbalances’ procedure that is to be introduced under the ongoing reform of eurozone governance goes in the right direction. But it also implies that the single-minded concentration of the European Union and the International Monetary Fund on fiscal adjustment in the EU periphery is misguided.

For Greece, fiscal adjustment is, of course, the key issue. For Portugal, however, the key problem is the private sector’s continuing external deficit. Ireland is different again, as it has very little foreign debt and will soon run a current-account surplus. Its government should then no longer need external financing, provided it can mobilize its own citizens’ savings. As shown by the experience of Latvia, risk premia can then come down very quickly.

In short, fiscal adjustment is a necessary but insufficient response by a country to extricate itself from a debt crisis. Fostering domestic savings, and getting citizens to buy bonds of their own government instead of keeping their money abroad, is just as important.