Opening Remarks

The Forgiveness Fix

For overburdened countries and consumers alike, erasing unpayable debt is a necessary step toward renewed growth
By Peter Coy

In America's unenlightened past, men who couldn't pay their debts were imprisoned. Languishing behind bars deprived them of any chance to repay their creditors, so the practice was stupid as well as cruel. During college, I carne upon a trove of heartrending petitions to the Connecticut General Assembly from women seeking to have their debtor husbands released from jail. The petitions were, by and large, rejected.

Society has come a long way since, but not far enough. There is still a presumption that blood can be squeezed from a stone. That's true in the U.S. housing market, where banks continue to insist that they will be able to collect full repayment of wacky mortgage loans that they never should have made in the first place. And it's true in Europe, where creditor nations and banks are dragging their heels on writing down the sovereign debt of Greece, Ireland, and Portugal.

Why does this matter? Because debt-public and private, foreign and domestic-is the No. 1 issue of 2011. The perceived danger posed by debt dominates the political conversation in Washington and is the reason for the British governmenfs austerity program. In the absence of strong economic growth, debt burdens around the developed world will remain onerous for years to come-and yet while countries are single-mindedly focused on paying down their debts, it will remain harder for them to implement pro-growth policies. Getting the global economy moving again means accepting that some debts will never be repaid-and the sooner they're forgiven, the better. "This will be the story going forward," says Daniel Alpert, managing partner of Westwood Capital, a New York investment bank.

This is not an argument for welching by debtors who just don't feel like paying up. Because the U.S. government, for example, is fully capable of covering all of the $14.3 trillion it owes, it should. And it will: The debt ceiling has been raised, albeit grudgingly, and even Standard & Poor's still gives the U.S. a near-perfect AA+ rating. The real problem for the U.S. lies ahead. If it doesn't bring revenues and expenses in line in coming decades, it really will be in a bad fix.

In contrast, there are some outstanding debts for which there is no prayer of full repayment. Collectively, U.S. consumers have reduced debt by more than $1 trillion since 2008, but for some, the burden remains intolerable. Start close to home, with American residential real estate. According to CoreLogic of Santa Ana, Calif., about 23 percent of mortgaged residences in the U.S. were worth less than the mortgages on them as of the end of March. In

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Nevada, the figure was 63 percent. Many of those homes' owners can't sell and move elsewhere to take a job because they can't raise the funds to pay off the loan. In a very real sense, "an underwater home is a new version of a debtor's prison," says Edward Leamer, an economist at the University of California at Los Angeles.

Better options exist. Mortgage lenders could let families stay in their homes, but as renters, or reduce what people owe to around the current value of the homes. (Banks could demand to capture the upside if the home price rebounds.) Writedowns would enable people to sell if they need to. That would also lessen the chance that they simply walk away, which forces the banks to take on a vacant and nearly unsellable piece of real estate. Banks have preferred to extend terms or lower rates, rather than write down principal.

Banks resist writedowns because acknowledging the losses would leave them severely undercapitalized, and this is a lousy time to repair their balance sheets by selling equity. (Bank of America shares are down more than 40 percent this year as the extent of its real estate problems has become apparent.) To break the stalemate, Alpert says the government should let banks record the one-time hit to capital in equal installments over 10 years.

There's a precedent for debt forgiveness. In the early 19th century, bankruptcy codes began to replace debtors' prisons, giving people a welcome chance to set things right. A business that seeks protection from creditors in court is given a chance to start again with a lighter debt burden, provided it can demonstrate that it's worth more to creditors intact than in liquidation. Households get a break from the hounding of debt collectors while they arrange a plan to pay as much of what they owe as is reasonably possible. The system is rational and orderly.

But the principies of bankruptcy Iaw aren't applied as widely as they could be. First-Iien loans on primary residences are exempted, so bankruptcy judges can't force lenders to share the pain with other creditors when someone goes bust. Their special status emboldens banks to lend unwisely and then to resist restructurings that would benefit other parties, says Barry Zigas, director of housing and credit policy at the Consumer Federation of America.

There's no bankruptcy court for sovereign nations, either, though international lenders are gradually coming to see the merits of debt relief, at least when it comes to the world's poorest countries. Since 1996, when the Heavily Indebted Poor Countries Initiative began, 22 nations have been promised debt relief totaling $100 billion, according to Jubilee USA. Zambia used some of the freed-up funds to control disease in livestock and reduce fees to attend school-spending that had clear public benefits.

The poorest countries are attractive candidates for forgiveness, since they owe relatively little and most of their loans are from official institutions like the International Monetary Fund and the World Bank. Middle- and upper-income countries like Greece, Spain, and Italy are less sympathetic victims, and their leveis of indebtedness present much bigger risks to the global economy. Spain and Italy can probably skate by paying everything they owe at subsidized rates or extended terms. But Greece has no chance. Only writeoffs will do.

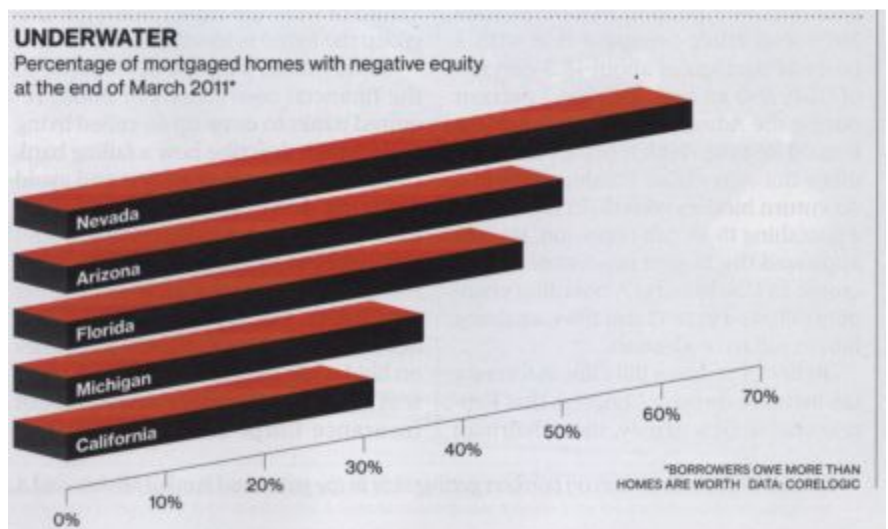
True, the Greeks are not without sin; tax evasion is rampant. But draconian budget cuts made at the insistence of European authorities and the IMF are simply making matters worse, depressing the economy and tax revenues, and potentially setting the stage for a disorderly default.

The July aid package for Greece takes a tentative step toward writedowns. Greece was promised €159 billion of new aid with lower interest rates and longer repayment terms, with private banks chipping in €50 billion of that through supposedly voluntary bond exchanges and buybacks. That will cut the amount Greece owes by at least €13.5 billion, according to the Institute for International Finance. But it's not enough; Greece's debt, at roughly one and a half times GDP, will still be unsupportably large. Will creditors stand for more of a cramdown? Yes, if it's the only alternative to a flat-out, Argentina-style default, which it may well be.

As recession threatens in the U.S. and Europe, Band-Aids will no longer suffice. The Federal Reserve announced on Aug. 9 that it would keep the federal funds rate at a microscopic zero percent to 0.25 percent for at least two more years. That's dangerously close to zombie economics-propping up weak debtors by enabling them to roll over their loans for almost nothing. Better to clean out the rot and get a fresh start, with interest rates determined by the market, not the central bank.

The classic argument against debt forgiveness is that it encourages bad behavior in the future. Borrowers will tend to take out stupid loans because they have reason to believe they will get bailed out again. But Ienders can succumb to moral hazard as well, if they're protected from the consequences of foolish lending decisions. Hand-over-fist lending to Greece during the boom times is a good example. Banks had an incentive to lend to Greece because under the Basel banking rules they didn't have to hold capital against sovereign loans.

Ultimately, the best argument for debt relief is that it helps to free the productive potential of the economy. Over-indebtedness stultifies growth today, just as surely as debtors' prisons did centuries ago. It's time to break the Iocks.



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