

Conference "Forging a practical plan to improve handling of sovereign crises"

22nd January 2014

The speaker of the conference is Brett House, senior fellow at the Centre for International Governance Innovation, who has written a paper on sovereign debt crises, in which he makes a number of proposals how to prevent them.

The discussion on debt restructuring may seem to be a bit late now. But financial crises come with regularity - approximately once every 10-15 years and vulnerabilities still exist. The issue of crises is of great importance right now and policy makers have their eyes on the issue. However, once the focus is lost, the discussion on the issue may go dormant and little progress is made. Having seen the rejection of SDRM, one can observe that there is no big political appetite for large reforms and "Big Bang" approaches. The focus must be on small and pragmatic approaches that do not require extensive negotiations to be implemented.

The vulnerabilities in the current systems are multiple and affect multiple countries across the world. Puerto Rico is close in default. Caribbean countries have went through restructuring in the 2000's, but find themselves under pressure again and can no longer restructure. Senior creditor status or quasi-senior creditor status can be in question in this situation and it might be necessary to return to the creation of something like a multilateral trust fund. In the West, the industrialised countries had their debt-to-GDP ratio increase by 3% of GDP. Similar increases happened twice in the 20th century, but both times the debt went down relatively quickly. Given current austerity measures and demographic change it is entirely possible to see the debt increase up to 150% of GDP by mid-2020's.

IMF paper, published in April 2013, opened the discussion. Until then, the general opinion was that debt restructuring has to remain relatively costly as sovereign debt is quite different from private debt. The paper pointed out that the sovereigns are not as likely to default too early and too easily with respect to the economic situation, as it was previously considered. The opposite looks to be more likely - the sovereign restructure too little and too late.

Given this diagnosis, there are 7 things that should be addressed. This points are not meant to bring the discussion back to the SDRM discussion, as all proposal that require IMF articles reform are nearly impossible, as evidenced by the last week's US Congress' vote.

1) The discussion must take a more continuous format. The problem is that the restructuring issue is raised at the times of crises and is then essentially dropped for several years.

2) Some kind of mechanism must be put in place, so that debtors and creditors can gather in one place in stages of distress, where the options for dealing with distress are wider and which would allow to prevent proceeding of the country into restructuring process, while preserving the value for both

parties.

3) Once the crisis has taken hold, there should be some automatic mean to put in place a payment standstill and assess the situation whether the problems are of liquidity or solvency. There are easy ways to fix it, which can be incorporated in contracts for sovereign bonds.

4) Moral hazard problem is still present around the state support. Agents may consider restructuring too late, as they rely on the state support. Greek hedge funds were considered as an example.

5) CAC's don't work that well and can be prevented from being activated in certain situations and cannot be relied upon entirely.

6) After NML vs. Argentina case, it is necessary to deal with what pari passu means, as it opens a possibility of raidable payments to hold-out creditors.

7) The problem of payment systems and holdout creditors needs to be addressed.

The first set of problems deals with ex-ante problems of debt restructuring, while the second deals with ex-post problems.

The work on these 7 points can take place in small, incremental steps. The Paris Club has proved that more than 400 debt restructuring can take place without formal institutions. Similarly, trade negotiations on GATT have also been taking place long before the WTO was involved. It shows that it is entirely possible to bring both private and sovereign players under one roof and achieve consensus.

The progress on the issues is currently taking place:

1) Informal groups are meeting to reform contract language, focusing on strengthening collective action clauses, especially supporting the 1-step collective clauses (as opposed to EU 2-step clauses).

2) Work is done on the jurisdiction regarding the holdout creditors.

The private creditors generally support the move to 1-step clauses, even though they generally diminish their rights.

Also, a creation of the Sovereign Debt Forum (SDF) is suggested. Its main tasks would be providing a center for continuous research of sovereign debt restructuring and providing a venue for discussion of financial distress and deal with the problem that sovereigns are reluctant to ask for assistance. In certain way it could be viewed as an extended Paris Club.

SDF operations would include open membership, rotating representation based on relevance, search for consensus instead of voting. American Bankruptcy Institute is a similar organization at the national level. The main motivation for participation of private agents is that the sooner distress is ended, the more value will be preserved.

SDF would provide a menu of opportunities that would be able to deal both with the ex-ante and ex-post problems of financial crises and would provide an agenda for meaningful incremental steps.

Commentary:

The starting point of the discussion are very substantial debt levels, similar to those after the World War II. Previously, it was resolved by rapid growth and inflation in the 50's and 60's, where the combination of this two factors was crucial. The problem is that the next 10-20 years are unlikely to be the repetition of the 50's and 60's. For example, in the 50's a large share of growth came simply from replacing the capital that was destroyed in the war. It is however hard to predict as technological innovations can promote growth as well, as was seen in the invention of the Internet. Inflation is also unlikely to ease the debt burden, as there have been disinflationary tendencies in several countries.

Debt restructuring is usually seen as a very painful process, which for example led to very painful negotiations in Greece. During this period the major winners were creditors, as they could avoid taking a haircut by selling bonds to hedge funds that were willing to take risks or also by replacing private creditors by public creditors. The safeguard is taken by the assessment of authorities whether the debt will be paid back, which is however a very difficult exercise due to a high number of assumptions and politics involved.

The problem with debt restructuring is the solvency problem, i.e. unwillingness of the political system to repay debt. Hence, solvency remains to be largely a political problem. The moral hazard problem is prevalent in this case. One of the solutions is to introduce an automatic debt restructuring and introduction of debt thresholds. The nice things about this is that it works as an automatic stabilization tool.

Open floor:

1) Isn't there a moral hazard problem with the countries knowing that if they reach some level of debt, it will be restructured?

The assistance program is triggered when a country seeks an assistance, which allows for moral hazard. An alternative would be to make a contingency on macroeconomics parameters. The important question is what indicators should be chosen.

2) Are there any lessons to be drawn from the situation of Puerto Rico and Caribbean countries? In application to Greece?

The dominant problem was that the restructuring in the 2000's was done too little and too late. The

countries face extreme weather distress, which was also harmful to the economy.

3) Should SDF be best attached to IMF, G20 etc.?

There are a lot of possibilities and the format is flexible. It can be incorporated as an NGO. The incorporation in G20 will also be negotiated. Also, the format of the Paris Club is possible.

4) What about the borrowing cost? If restructuring become too easy, markets should attach a premium on that.

The good example would be to take a look at the situation before the incorporation of CAC's in contracts in emerging countries in 2003, first in Mexico for example. Up until then, CAC were featured in British and American bonds, so you could observe the situation in similar countries under different scenarios, however the rates have remained on similar levels. While this assumption makes sense in theory, it does not entirely hold in practice.

Conference notes by Sergiy Golovin