Sovereign Debt Restructuring: What is the Problem?[1]

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When Gertrude Stein, the great American feminist, was ill and dying in Paris, she is reported to have turned to her longtime companion, Alice Toklas, and asked her "What is the answer?' When Toklas replied she did not know, Stein responded "What then is the question?" The lesson is clear: if you do not know the question, you cannot get the answer. It is therefore fitting that today's conference on the Sovereign Debt Restructuring Mechanism (SDRM) begin with a session titled "What is the Problem?"

With regard to this question, I identify two broad categories of problem. One category is macroeconomic, and concerns the build-up of indebtedness and the consequences for credit markets and the global economy of being unable to efficiently restructure. The second category is microeconomic, and concerns how to construct an efficient system for re-structuring sovereign debts.

The macroeconomic problem derives from the build-up of large debts that countries are unable to support. This creates a permanent climate of financial instability. It also results in high interest rates that are needed to compensate for default risk, and which retard economic development. Past country debts – sometimes referred to as the debt over-hang – also impede access to new investment financing, even though new

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[1] Presentation given at a Conference on the Sovereign Debt Restructuring Mechanism held at IMF Headquarters, 700 19th Street, NW, Washington, DC January 22, 2003. Comments are based on a more extensive working paper titled "The Economics of Sovereign Debt Restructuring: The Case for a Chapter 9 International Bankruptcy Court." The views expressed here are those of the author and not those of the Open Society Institute.

investments may have high marginal returns. Together, these features exert a negative impact on both individual countries and the global economy.

In addition, the inability to efficiently re-structure debts exerts a negative impact on policy and credit markets. Under the existing system, costs of default are large for countries, and they are also potentially large for the global economy owing to contagion effects. To avoid these costs, countries have an incentive to "gamble for redemption," taking on additional high interest rate loans in the hope of escaping default. Side-by-side, the IMF also has an incentive to extend additional loans, so that solvency crises get treated as if they were liquidity crises. The net result of this policy treatment is that private sector lenders get bailed-out and moral hazard is created in international credit markets.

At the microeconomic level, there are several problems with the existing system. First, restructuring negotiations under both the Paris and London club arrangements are long and uncertain, giving rise to economic dislocation during the negotiating period. Second, there is inadequate protection for new lending during the negotiation period, and this discourages the flow of needed new financing. Third, there is an absence of uniformity of treatment across creditor classes. Fourth, there is the collective action problem associated with getting creditors to agree. This collective action problem obtains within a specific creditor class (the hold-out or vulture fund problem) and across creditor classes (the aggregation problem). Finally, all of these problems are worsening owing to the shift away from bank loan financing to more diversified sources of funding.

A range of different solutions have been proposed for these problems. One solution is more extensive use of collective action clauses in sovereign bond contracts. A second solution is the IMF's Sovereign Debt Restructuring Mechanism (SDRM) with a Sovereign Debt Dispute Resolution Forum (SDDRF). A third solution is an international bankruptcy arbitration court, and here there are two possibilities. One is an arbitration court modeled after U.S. Chapter 11 bankruptcy procedures in which only debtors and creditors have standing. The second is a U.S. Chapter 9 procedure in which civil society representations also have standing. For policy makers, the test should be how well each proposed solution deals with the underlying problems.

The IMF (2002) has laid out in considerable detail how its SDRM/SDDRF proposal would work. In doing so, the Fund has done all of us a great service, providing a benchmark against which to assess proposals. However, having become the benchmark, the Fund's proposal must also now serve as the fulcrum of comment.

Given the limited availability of time, I will restrict myself to three observations. First, the Fund's proposal is filled with references to concern for "contractual rights," and this concern is repeatedly invoked to argue against certain forms of arrangement. This argument is specious. Contractual rights are a legal construction, and they can and should be changed in accordance with what is deemed to be best for the public interest.

Second, the process envisaged by the SDRM/SDDRF proposal is a debtor – creditor negotiation, with ultimate agreement requiring the approval of a super majority of each class of creditors. The outcome of this process depends significantly on its design. As currently proposed, it strikes me that the design is structured to augment the negotiating power of creditors. This can be seen in the absence of a provision for a stay of enforcement, continued accrual of interest, the manner in which negotiation costs are charged, and the nature of the rule providing for new priority financing.

A third issue concerns the treatment of official creditors. This is a difficult intellectual question, and one where my views are evolving. On one hand, it can be argued that official creditors should be excluded (unless they elect otherwise) on the grounds that the sovereignty of creditor countries must be respected just as must the sovereignty of debtor countries. However, the SDRM/SDDRF works by super-majority agreement rather than binding arbitration, and there may be good reason for inclusion of official creditors. Moreover, they should be included as part of a single class that includes private sector creditors. This would ensure inter-creditor equity, the lack of which is a recurrent private sector complaint. Yet, at the same time governments would inject a public policy concern into negotiations, and their votes could help achieve the super-majority needed for efficient restructuring.

Regarding the international financial institutions (IFI), there are also good arguments for including their debts. If the loans of government development agencies are going to be subject to restructuring, then so too should the loans of the multilateral development banks. This threat could even improve multilateral bank lending performance since the banks would have a real incentive to see that their loans are productive and contribute to development. It would also encourage the banks to internalize country macroeconomic performance in lending decisions, and this could yield additional benefits. First, countries would be encouraged to adopt sound macroeconomic policies to get multilateral bank loans.[2] Second, where macroeconomic fundamentals did not warrant making loans, the development banks could instead make grants if deemed appropriate.

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[2] In a sense, this would provide incentives to pursue good macroeconomic policies in a fashion similar to President Bush's proposed Millennium Challenge Account initiative.

Having IMF loans subject to the possibility of restructuring could also potentially yield policy benefits. In particular, having IMF loans be subject to potential restructuring would likely reduce moral hazard in credit markets since the Fund would only lend in cases of liquidity crisis or where there is a need for temporary balance of payments assistance. Moreover, it would also get the Fund out of the business of long-term structural adjustment, and it would stop the Fund from bankrolling risky policy experiments associated with financial market liberalization, currency boards, and nominal anchor programs where countries accrue significant foreign currency denominated liabilities.

Finally, if official and IFI debts are included, it may be desirable to have some provision for public disclosure of the creditor voting record. This would allow the ultimate shareholders of these groups – the public – to know how they are voting. Indeed, a case can be made for private institutions revealing how they vote, just as mutual funds should reveal how they cast their proxy votes.

Let me conclude with a mundane observation. The impetus for reform tends to fade in periods of stability, but that does not mean the need for reform has gone away. Today is a moment of stability, and the need for reforms that allow efficient sovereign debt restructurings remains intact.

References

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