Creating a Sovereign Debt Restructuring Framework that Works

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December 2015
RIDGE Forum, Montevideo
Outline

• The objectives of debt restructuring
• The current situation
• The ICMA-IMF response and its limitations
  • Other possible improvements within the contractual approach (SCDSs, GDP indexed bonds, champerty)
• The UN approach
The objectives of debt restructuring

• Bankruptcy regime attempts to balance
  • Ex-ante efficiency (credit assessment, risk-taking)
  • Ex-post efficiency (Efficiency in the restructuring process)

• Excessive penalties would induce delays

• As a result of excess indebtedness, there is a massive waste of resources

• Private outcome is likely to be Pareto inferior

• Market equilibrium characterized by failures (coordination, bargaining, signaling)

• Part of the explanation for existence of domestic bankruptcy laws
The current situation

• But there is no international bankruptcy law

• “Too little, too late” syndrome
  • Since bonds replaced loans, 40 per cent of restructurings ended in re-default or another restructuring within five years (Gelpern 2015)

• And finalization of restructuring could take too long
Recent case: Argentina and the US Courts

- Argentina defaulted in 2001
- Two rounds of restructuring: 2005 and 2010
  - 92.4% of acceptance
  - 1% litigates (debt purchased in default state)
- Griesa's ruling: peculiar interpretation of *pari passu*. Vultures' victory
- Is Argentina an exception?
The current situation

• Remedies on the table:
  • Improvements within the private contractual approach (ICMA-IMF)
  • A multinational framework for sovereign debt restructuring (United Nations)
ICMA’s response

- CAC and Pari Passu
  - Improvements over the old terms
  - But not sufficient to solve the current problems
    - Do not solve the problem for the existing debt stock
    - Multiple inter-creditor equity problems
    - Coordination problems
    - Political economy problems
ICMA's response and inter-creditor equity problems

- Problems for determining priority with debt issued in different jurisdictions
- Problems of determining valuations with debt issued in different currencies
ICMA's response and inter-creditor equity problems

- The backgrounds of the negotiations are biased against the “implicit creditors” (workers, pensioners)
- IMF bailout policies favor short-term creditors and hurt long-term creditors, including the implicit creditors
Coordination problems

• With heterogeneous debtors and imperfect information, the market solution leads to a suboptimal signaling equilibrium

• Makes demand for “tough” jurisdictions inelastic
Political economy problems

- It doesn't solve political economy problems both on the debtor's and creditors' side
Possible improvements within the contractual approach

• Full disclosure of SCDS positions
Possible improvements within the contractual approach

- Variants of champerty into contracts
- GDP indexed bonds
Guidelines for a Framework for Sovereign Debt Restructuring

• Must recognize the limitations of the market-based approach
• Must provide the conditions for timely restructurings
• Must be aware of the minimum set of principles over which the parties involved would agree on
UN Principles

- Sovereign's right to design macro policy including right to initiate restructuring
- Good faith
- Transparency
- Impartiality
- Equitable treatment of creditors
- Sovereign Immunity
- Legitimacy
- Sustainability
- (Super)-Majority Restructuring

They have not been respected in recent restructurings, which led to inefficient and inequitable outcomes
Guidelines for a Framework for Sovereign Debt Restructuring: A Possible Framework

• Sovereign initiates the restructuring

• System should incentivize no delays
  • Stays for litigation
  • Lending into arrears

• Stage of possible objections by other parties

• Alternative proposals must justify how they recreate the conditions for sustained growth (instead of just re-creating conditions for repayment in the short-term)

• Proposal should describe the impacts on all stakeholders
Guidelines for a Framework for Sovereign Debt Restructuring: A Possible Framework

- End of the process depends on type of mechanism: Hard law vs. Soft law
  - **Hard law**: An International Bankruptcy Court would require that countries that adhere to the mechanism sacrifice sovereign immunity
    - And would be associated with complex geopolitical problems
  - **Soft law**: An Oversight Commission (composed by other States that endorse the Multilateral Framework) would act as a supervisor and mediator, but based on the UN principle that no country can sign away its sovereignty
    - It would not have the capacity to rule over the final proposal, but could make statements on its reasonableness
    - Therefore, it would legitimate the outcome of the restructuring process
Conclusions

• Current non-system doesn't achieve the objectives of sovereign debt restructuring

• ICMA-IMF proposal will improve some aspects but will not provide a comprehensive solution

• Space for improving contracts, legal frameworks, and IMF bailout policies

• But with incomplete contracts, the private contractual approach will not suffice (and contracts will always be incomplete)

• Calls for a statutory approach that complements the contractual approach
  • A more efficient restructuring process could lead to lower interest rates

• UN principles are a step in the right direction