

Fixing Sovereign Debt Restructuring

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Outline

- The objectives of debt restructuring
- The current situation
 - The “Too Little, Too Late” Problem
 - The Vulture Funds
- The Contractual Approach response and its limitations
 - Possible improvements
- The guidelines for a Framework for Sovereign Debt Restructuring

The objectives of debt restructuring

- Bankruptcy has a central role in modern capitalist economies
 - Hard to imagine a modern economy without limited liability and the possibility of debt restructuring
- Both efficiency and equity dictate a fresh start
 - As a result of excess indebtedness (as in Europe), there is a massive waste of resources
 - Resources before the crisis are the same as after
 - Debt is just an obligation
 - The problem is that there is an “excess” of claims
 - Disputes over how to satisfy excessive claims destroys resources

The objectives of debt restructuring

- 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
- A system of orderly discharge of debts would lead to more efficient use of resources in the present

The objectives of debt restructuring

- Bankruptcy regime attempts to balance:
 - Ex-post efficiency
 - Ex-ante efficiency (credit assessment, risk-taking)
 - Efficiency in the restructuring process
 - Excessive penalties would induce delays

The current situation

- There is no international bankruptcy law
- “Too little, too late” syndrome
- The Vulture Funds
 - Judge Thomas Griesa ruling over Argentina’s case makes debt restructuring *de facto* impossible
 - Creates both inefficiencies and inequities in global financial markets

Policy questions

- Are there quick fixes within the private contractual approach?
- To what extent will they solve the problems
- What are the principles that should guide the design of a FSDR?

ICMA-IMF's response

- CAC and *Pari Passu*
 - Improvements over the old terms
 - But not sufficient to solve the current problems
- Limitations:
 - Do not solve the problem for the existing debt stock
 - Multiple inter-creditor equity problems
 - Coordination problems
 - Do not solve political economy problems

ICMA-IMF'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-IMF'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
- As well as the ESM does so in Europe
 - Mechanism for bailouts, not for restructuring, that worsens the situation of unsustainable debtors and creates inequities

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

- The costs of restructuring are usually borne by different political actors than those who created the problem
- A system that makes restructurings too costly exacerbates these tensions, as it incentivizes debtors to delay the recognition of problems
- Creditors' behavior may also exacerbate these tensions
 - Particularly so when they provide short-term lending at high interest rates to countries that are in obvious need of a restructuring, taking into account the distorted incentives of the distressed debtors to recur to those funds
 - The political economy of the official creditors play into this.
 - Creditors should bear part of the responsibility for lending under such conditions

Possible improvements within the contractual approach

- Full disclosure of SCDSs
- 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
 - It needs to ensure flow of funds to developing countries
 - It needs to solve the “Too Little, Too Late” syndrome
 - It needs to put an end to vulture funds’ business
- Must be aware of the minimum set of principles over which the parties involved would agree on

Guidelines for a Framework for Sovereign Debt Restructuring

1. Sovereign initiates the restructuring
2. System should incentivize no delays
 - Stays for litigation
 - Lending into arrears
3. 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

- 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
 - 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

Minimum Agreement

- Restoration of principle of sovereign immunity
 - It should be impossible to sign this principle away
 - Implementable through restrictions on admissible contracts

Conclusions

- SDR nowadays featured by lengthy and intricate negotiations
- Conditions apt for emergence of destabilizing vulture funds, with systemic implications
- Recent evolution of legal frameworks played in favor of the vultures business, not in favor of global social welfare
- There is space for improving contracts, legal frameworks, and IMF bailout policies

Conclusions

- But with incomplete contracts the private contractual approach will not suffice
- A formal framework for SDR is necessary
- A more efficient restructuring process could lead to lower interest rates
- A “soft law” approach that entails a more active role for a quasi-judiciary can mitigate some of the current inefficiencies and inequities
- Its absence would imply still further problems in SDR of the type described in this presentation