Fixing Sovereign Debt Restructuring

United Nations
July 28th 2015

Joseph E. Stiglitz
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