Solutions and Crisis Prevention for Sovereign Debt Default

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RICHARD ROUSSEAU, AUG 27 2013

The world urgently needs a mechanism to more effectively manage the financial crises that develop when debtor countries are unable to repay their international debts.

The rapid expansion of international capital flows has been one of the dominant characteristics of globalization. Whilst highly beneficial for some market players, in some cases speculative attacks have brought about considerable economic and social damage to several countries. The last three decades witnessed a significantnumber of financial crises, which mostly impacted emerging market economies but were also felt in highly developed economies. The debt crisis in Latin America in the 1980s, the Asian crisis of the late 1990s and the American-born Global Financial crisis of 2007-2008 brought financial turmoil created by sovereign debt into public prominence. Addressing this issue became part of the official agenda following spectacular sovereign defaults, such as that of Argentina at the beginning of the century.

Creditors bear a significant share of the risk of debtor default in almost all states' domestic insolvency legislation. Yet, no international mechanism has been established to involve creditors in crisis resolution within the global credit market. Consequently, in the vast majority of liquidity/insolvency crises the risk is effectively borne by debtors. This lack of balanced legislation on responsibility encourages reckless creditor behaviour and encourages a dangerous cyclical pattern in global credit markets. Though offering a seemingly attractive environment for investment due to their booming economic activity, which is largely driven by credit, emerging market economies are usually more predisposed and susceptible to sovereign defaults.

Collective Action Problems

Recent times have witnessed the emergence of 'collective action' problems, which pose systemic worries for policymakers. Each creditor has an incentive to act in its own perceived self-interest, which usually results in suboptimal outcomes for the group of creditors. One of these collective action problems is the 'rush-to-exit problem,' in which investors tend to lose confidence in the sustainability of a debtor economy and try to withdraw their investments all at once. This 'run on the banks' type of reaction transforms financial crises into potential defaults. Another problem is that while creditors have no choice but to negotiate debt restructuring with a state, some obstinate individual ("holdouts") investors may use strategies that are counterproductive to macro policies as a whole. Such lone wolf investors can actually hinder the structuring of an agreement should they decide to "free-ride." Moreover, individual investors are more prone to sue the debtor should the debt not be serviced, as several examples have confirmed.[i]

Within a widespread and diversified creditor community, individual investors, acting rationally, may obstruct a solid and orderly debt restructuring, even under a sound national insolvency procedure. The population of the troubled country usually pays the biggest price for the swings of capital flows simply because the state ends up bankrupt.

Despite officials and individual players in the market being well aware of such issues, no international consensus exists as to how to establish a restructuring mechanism in a situation of debt crisis. Systemic vulnerability to debt repayment delays and crises resulting from them clearly demonstrates that a solution is urgently required. But economists and policymakers are challenged by the two questions of how to find the most effective debt restructuring mechanism when it becomes necessary and inevitable and what kind of regime can ensure an orderly restructuring, whilst balancing the rights of both the creditor and debtor.

A number of concepts are competing in the search for collective action solutions in a default situation. For instance, after the Argentina default in December 2001, the International Monetary Fund (IMF) launched an initiative called the Sovereign Debt Restructuring Mechanism (SDRM), but came up short in the political battle with the U.S. Treasury and emerging-market elites. The IMF sought to introduce a new statutory framework for a debt resolution mechanism applicable to all its members and all types of sovereign debt. The SDRD mechanism was intended to provide benefits to market actors – the main creditors – and emerging markets – the main debtors.However, the existing framework, which is predisposed to foster an anarchic system of market failure, proved more attractive than this new IMF initiative. An IMF bailout proposal was retained in the end. Hence, the international community still awaits the creation of a formal mechanism which could be used to effectively address sovereign debt crises and stop the short-sighted pro-cyclical incentives for creditors and debtors alike.

Following Argentina's default on its debts, the business community launched the idea of Collective Action Clauses (CACs) in countering the SDRM. Highly successful, CACs appeared to be a brilliant and graceful solution, as they aimed to solve collective action problems of single bond issues, a serious barrier to debt restructuring. However, several shortcomings could be noted. Above all, they did not address the massive load of pre-existing debts, the main source of the insolvency problem.

More far-reaching in terms of instituting a regulatory approach, proposals from non-governmental organisations (NGOs) offer interesting solutions, although they have not yet entered the political debate. Nonetheless, since a universal mechanism is still absent, they could yet be influential. One is a non-statutory approach proposed by Kunibert Raffer, Senior Associate of the New Economics Foundation (London). His proposal is analogous to the principles of U.S. municipal insolvency and basically tries to resolve the conflict between two fundamental legal principles: first, the right of creditors to interest and repayment and, second, the general understanding that "one must not be forced to fulfil contracts if it leads to distress, endangers life or health, or violates human dignity." Raffer's proposal recommends that risk and liability must be the most important elements in international credit relations. However, since a universal mechanism is still absent, the utility of this suggestion is questioned and its acceptance may be blocked by consumer advocacy groups and other influential stakeholders.

Another approach is the Fair and Transparent Arbitration Process (FTAP), which proposes the creation of an ad hoc arbitration panel whose members are nominated by both creditors and debtors. In this approach, the conflicting parties have to agree on a framework of operational rules to govern the work of the panel, while the debtor's sovereignty is strongly emphasised. The court may not interfere with political or governmental powers without the debtor's consent. The principle of debtor protection requires that financial resources to service a country's debt must not be used at the expense of its economic future; the debtor is allowed to maintain basic social services as part of such a workout. The main purpose is to guarantee the protection of a "creditor from the economic duress of his debtor."[ii]

A standstill period, which operates as a stay of claim enforcement against the debtor, can be afforded to a sovereign country in order to protect it from creditors. Arbitrators are then tasked with mediating between debtors and creditors. Also, civil society representatives have the right to be heard within such a mechanism. Arbitrators can make decisions in only two situations: when debtors and creditors, for whatever reason, cannot reach an agreement; if representative institutions demonstrate that a proposed agreement would saddle a population with too heavy a burden.

One more important principle it that debt relief has to be negotiated within an arbitration panel. So-called odious debt, which may legally be defined as a debt incurred by corrupt governments without the consent of the people and that was not used for their benefit, cannot be included in the amount of debt to be restructured. The IMF, and other international financial institutions bear the onus of making sound financial advices and are thus responsible for any losses resulting from it.

Another sovereign debt default approach is the International Debt Framework (IDF). This approach gives priority to the negotiation between a debtor government and all creditors. It provides "a middle ground between a legally binding insolvency procedure and a voluntary code of conduct"[iii] between various private debt holders officials of sovereign states. Suggested by Kathrin Berensmann and Frank Schroeder, it concentrates on crisis prevention and crisis resolution.

An IDF secretariat, made up of a small group of experts on debt and economic development, would be formed in order to prevent the eruption of debt crises and would work together with the Group of 20 countries (G20). The secretariat would serve as a channel of communication between debtors, creditors, and financial-market experts. The latter would gather information on emerging countries' debt markets and conduct risk assessments.

For crisis resolution, Berensmann and Schroeder suggest the establishment of an ad hoc commission which would try to guarantee fair treatment and good-faith during the negotiation period. An unsustainable debt would oblige the debtor to initiate the restructuring mechanism. Representatives of the sovereign debtor, sovereign creditors, multilateral lenders and private creditors would be appointed to a commission, while a stay on litigation would be bound to certain conditions. The following mediation process would set up an economic adjustment plan to support long-term debt sustainability, the amount of financial aid during the implementation period, and (if deemed necessary) the level of debt relief.

Both FTAP and IDF advocates say they want to address the inadequacies of the current system, but what makes their proposals a 'better' solution than existing mechanisms?

Any solution would have to be inclusive, that is, engaging a broad range of stake-holders. It also would have to be equitable, that is, introducing a more symmetrical sharing of the monetary costs between debtors and creditors. In addition, any proposals for debt restructuring must take into account the collective action problem and include a solution to it.

The notion that the G20 should be the global forum to negotiate unsustainable debt and financial instability between a debtor government and all creditors is questionable insofar as a significant number of countries do not have a seat at the G20 table. There is no doubt that members of that organization are key players in the international financial system; however, in such a forum the IDF secretariat would be created, above all, with the G20 members' interests in mind. The main risk is that the composition of the IDF commission (the crisis resolution body) would transfer the main decision-making power to the G20, which decreases rather than increases inclusivity.

Under the FTAP, all states could use the mechanism and be treated equally. Debtors and creditors would be involved to the same degree and other affected entities (e.g. civil society) would have a right to be heard. The FTAP mechanism provides for the involvement of a wide range of stakeholders through regular dialogues.

On the issue of debt relief, both the IDF and the FTAP provide for a more just burden-sharing for parties involved in the debt crisis, although the IDF proposal is very short on specifics. An important aspect is the method used in determining the level of the debt relief. The IDF assumes that the commission, if necessary, would be required to perform this task, but this approach offers no concrete mechanism. The FTAP is in favour of cancelling all debts that are considered "uncollectable."[iv] Odious debts are also excluded from debt negotiations. Consequently, the FTAP shifts the responsibility of excessive sovereign debt to creditors who engage in over lending and who were sufficiently concerned about the creditworthiness of borrowers or the nature of the activities they were financing. This permits the monetary cost of indebtedness to be more equitably distributed among stakeholders.

Mediation versus Arbitration

The analysis of IDF's and FTAP's effectiveness results also in the discovery of major differences. For instance, the IDF favors mediation, while the FTAP gives priority to arbitration. Normally, mediation is considered a satisfactory approach, since any agreement is generally followed by a high degree of compliance. However, suppose that one of the parties refuses to sign the agreement, or a number of creditors ultimately do not agree with implementing the final decision, then the IDF provides no alternative mechanism to solve the deadlock situation. This is made all the more problematic since the IDF proposal does not provide any enforcement mechanism for effective sanctions.

Under the FTAP, an arbitration panel with jurisdictional powers would be set up if it were otherwise impossible to reach an agreement. This panel's final decision would be binding on all parties and there would be a mechanism for imposing punitive sanctions in the event that one or both parties do not adhere to it. These binding decisions deriving from arbitration are potentially more effective in producing results than those achieved through mediation.

With regards to the problem of collective action and its resolution, the two approaches contain qualitative differences. The IDF has developed the concept of "exit consents" (also known as "exit amendments") to cope with pre-existing debt stock and address the free-rider problem.

"Exit consents"[v] permit a simple majority of bond issuers to amend the terms of a bond contract, thus making the old bond issue less attractive than a new one. Such a mechanism provides an incentive for creditors to participate in restructuring and reduces the incentive for holdouts to abstain from participating. Within the FTAP, the binding character of the final award would in itself resolve this problem.

Both proposals endorse a stay on enforcement as a means of addressing the rush-to-the-exitproblem. The IDF approach stipulates a 90 day suspension of debt servicing, with the additional option of a stay on litigation. The FTAP advocates unlimited stays on both debt repayment and litigation. Since selling bonds is more difficult under a stay on enforcement, the FTAP is an efficient way to contend with the rush-to-the-exits.' It enhance the debtor's ability to coordinate repayment to its creditors and obtain new financing, if necessary.Moreover, it accelerates debt restructuring, as creditors see an incentive to be part of such a debt workout. In the end, the rush-to-the-exit problem is adequately addressed by both proposals.

However, the IDF lacks an automatic stay on litigation, and this apparent shortcoming might provoke a different problem: the "rush-to-the-courthouse" problem. The expiration of the stay must be regulated, as the creditor might otherwise initiate legal proceedings against debtors. In contrast, the FTAP contains a stay on enforcement accompanied by a stay on litigation clause, thereby reducing overall litigation risks.

In summary, the FTAP's main strength lies in its provision of a fully inclusive and equitable mechanism absent from the IDF. The combination of both an arbitration process and a sanction mechanism within the FTAP makes it more adequate than the IDF, whose mediation process framework does not include an adequate enforcement mechanism. The rush-to-the-exit and free-rider problems are adequately addressed by the IDF proposal, while the rush-to-the-courthouse problem could prove troublesome.

Best Possible Option

In the final analysis, the FTAP is considered to be the best and most robust approach available. Nevertheless, the "exit consents" and other features of the IDF are useful, to the degree that they could even be incorporated into the FTAP. However, to effectively enforce negotiation results and achieve an optimum solution, the universality of the approach is absolutely necessary. In order t achieve such an approach, an international consensus, as explained, would be needed, something that, for a lack of resolve, the international community and its major actors have not been able to bring about in recent years. Whenever a country declares an all-out default on its sovereign debt, usually an assemblyof global financiers and state officials are positioned to call for two fundamental changes: first, better preventive regulations; second, better crisis settlement mechanisms.

Because of the spread of Collective Action Clauses (CACs), there is currently, to all intents and purposes, only one instrument (FTAP) that is capable of easing the coordination amongst creditors of a single bond issue in a default situation. But the three mechanisms discussed here provide comprehensive solutions to issues that in the past could only be addressed in part. While the SDRM and the IDF, IMF's offshoots, can be lauded for their strong pragmatic orientation, the FTAP is certainly more far-reaching, inherently impartial, and ultimately more efficient than are other approaches. Yet, during its implementation it has to overcome significant obstacles that stand in its way. The truth is that many vested interests have shut the door to all instruments with the exception of the CAC approach.

The two proposals that we have examined point by point would lead to a more orderly, transparent and timely insolvency procedure.Regardless of the merit of such an approach, the fierce opposition to any modification of the regulatory framework can be explained by the fact that any insolvency mechanism transfers the risks of sovereign default from debtors to creditors.

Also, the growing ties between nations over the last decade have made each and every one of them less inclined to allow their partners to go under. For all the current discussion about debt default, stemming from the crises in Greece, Spain, Italy and Portugal, the reality is that sovereign default has largely disappeared from the international economic scene. In their book, *The Time is Different*, Carmen Reinhart and Kenneth Rogoff chart how surprisingly commonplace default once was: In a typical year between 1920 and 2003, nations representing at least 5 to 10 % of the world's total income were in default, and that proportion spiked to 40 % during the Great Depression and World War II, and close to 15 % in the late 1980s. But since 2003, when synchronized global boom began, the share of defaulting nations has dropped from 5 % in any year to zero. No rich country wants to suffer a default, which may potentially lead to a hard landing, or to risk the spillover effect of a hard landing among its neighbors.

Despite this trend, the capitalist system needs a global debt framework since it would engender a more cautious behaviour among creditors and put downward pressure on the propensity to over-borrow in the international credit market. Sovereign debt crises in Eastern Europe (Slovenia, Hungary, Estonia), and now the uncertainfinancial stability of many Western European countries, make the creation of such an operational framework all the more pressing.

The international financial community must go beyond its selfish and narrowly defined interests and come to the realization that current financial 'rules' are too sketchy. Innovative concepts that can be applied to solve the problem of sovereign debt restructuring have laid for too long on the desks of IMF and NGOs experts; they deserve a greater investigation, primarily for what they might offer in terms of prevention and intervention.

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Richard Rousseau *is Associate Professor and Chair of the Department of Humanities and Social Sciences at the American University of Ras Al Khaimah, United Arab Emirates. His research, teaching and consulting interests include Russian politics, Eurasian geopolitics, international political economy and globalization.*

[i] See Raffer, Kunibert (2007), Risks of Lending and Liability of Lenders, Ethics and International Affairs, Vol. 21, Issue 1 (March): 85–106.

[ii] Pearce, Luke (2008), "Foakes v Beer and Promissory Estoppel: A Step Too Far, King's Law Journal", Volume 19, Number 3, p. 639.

[iii] Berhard, Regina, Kellermann, Christian (2008), Against All Debts? Solutions for Future Sovereign Defaults, Journal for International Relations and Global Trends, (1): p. 124.

[iv] Raffer, Kunibert (2003), 'The Present State of the Discussion on Restructuring Sovereign Debts: Which Specific Sovereign Insolvency Procedure?', in UNCTAD (ed.) (2005), *Proceedings of the Fourth Inter-regional Debt Management Conference and WADMO Conference,* 10-12 November, UN: Geneva & New York, p. 6

[v] Berhard, Regina, Kellermann, Christian (2008), Against All Debts?… p.126.

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About the author:

Richard Rousseau is Associate Professor and Chair of the Department of Humanities and Social Sciences at the American University of Ras Al Khaimah, United Arab Emirates. His research, teaching and consulting interests include Russian politics, Eurasian geopolitics, international political economy and globalization.