Sovereign Debt Restructuring: Current Challenges, Future Pathways

Presented by Domenico Lombardi
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CIGI

Outline

- A backgrounder on sovereign debt restructuring
- Global consultations on sovereign debt restructuring
- Preliminary feedback from global consultations

Sovereign Debt Restructuring: The Basics

- Sovereign debt restructuring is an exchange of outstanding government debt, such as bonds or loans, for new debt products or cash through a legal process. It can take one or both of two forms:

  1. ***Debt Rescheduling***: extending contractual payments into the future and, possibly, lowering interest rates on those payments.

  2. ***Debt Reduction***: reducing the nominal value of outstanding debt.

- Sovereign defaults and debt restructurings have occurred regularly since the early 19th century. Since 1950, there have been over 600.

- Recent developments strongly suggest that sovereign debt crises will remain a serious problem in the coming years.

- At the same time, new challenges and opportunities to governing sovereign debt – including through restructuring – are emerging.

New Challenges

- The ***euro zone crisis*** showed that sovereign debt crises, which now affect "rich" countries, are not going away or getting any easier to resolve.

- It also revealed new, or intensified, economic challenges associated with sovereign debt distress, and the handling of the crisis revealed significant gaps in the way sovereign defaults and debt restructurings are governed.

- More recently, the legal battle between Argentina and its "holdout" creditors (***Argentina v. NML Capital***) has cast uncertainty on the legal aspects of sovereign debt and the viability of smooth restructurings in the future.

- At the same time, sovereign debt burdens are rising to dangerous levels in many African countries, and are becoming more of a challenge for other developed and developing countries.

New Opportunities

- Relative power in the global economy is shifting from advanced economies to developing and emerging ones, creating new important players – with their own priorities and interests – in global economic governance.

- Emerging economies will become increasingly important in shaping the international sovereign debt architecture.

- For instance, as the world's largest creditor, China has a direct stake in promoting strong (rule-based) system for preventing and resolving sovereign debt difficulties. Its creditor status gives China growing influence.

- The IMF is looking to reform its lending framework to better deal with cases of sovereign debt restructuring.

- At the urging of the G77, the UN General Assembly recently passed a resolution that mandates the UN to create a "multilateral legal framework for sovereign debt restructuring."

Global Consultations on Sovereign Debt

- The Global Consultations on Sovereign Debt were initiated by the Centre for International Governance Innovation (CIGI) and are being coordinated by the New Rules for Global Finance Coalition.
- The Consultations seek to identify the full spectrum of proposals and ideas for addressing sovereign debt crises, and organize these ideas in a way that moves the debate forward.
- To do so, they bring together, and galvanize input from, a diverse group of stakeholders around the world, including academics, civil society groups, government officials, lawyers and legal experts, international organizations, practitioners, think tanks, and others.
- Independent from any official/multilateral organization

Global Consultations (Cont.)

- Participation in the Consultations is organized around Webinar discussions, video conferences, workshops, meetings, and written responses to a broad Issues Paper on sovereign debt restructuring.
- As part of its broader global engagement, CIGI has also co-hosted a series of regional workshops on sovereign debt restructuring (first in China, then in Uganda, and in Mexico) to take stock of regional experiences and perspectives on a timely and critical issue.
- Once the Consultations are concluded in June 2015 with the final event at the Argentina's Pavilion at the Expo in Milan, CIGI will be releasing a report that synthesizes the contributions from these various stakeholders in a way that can engage with, and inform, mainstream debates on sovereign debt restructuring.
- http://www.new-rules.org/what-we-do/sovereign-debt-consultation

China's Concerns and Interests

- When it comes to sovereign debt, China's main concern has to do with "safeguarding the value of its overseas assets from the detrimental effect of macroeconomic policies of Western countries, especially the United States."
- China also lends large amounts to Africa and other regions, including Latin America, and thus has a large stake in how sovereign debt and debt difficulties are managed there.
- China thus has a strong interest in promoting a rule-based system that does facilitate necessary restructurings and, in doing so, discourage over-lending and the mispricing of risk.

China's Concerns and Interests (II)

- International institutional reforms on sovereign debt need to go well beyond the helpful but modest proposals in the June 2014 IMF paper on revisions to its lending framework.

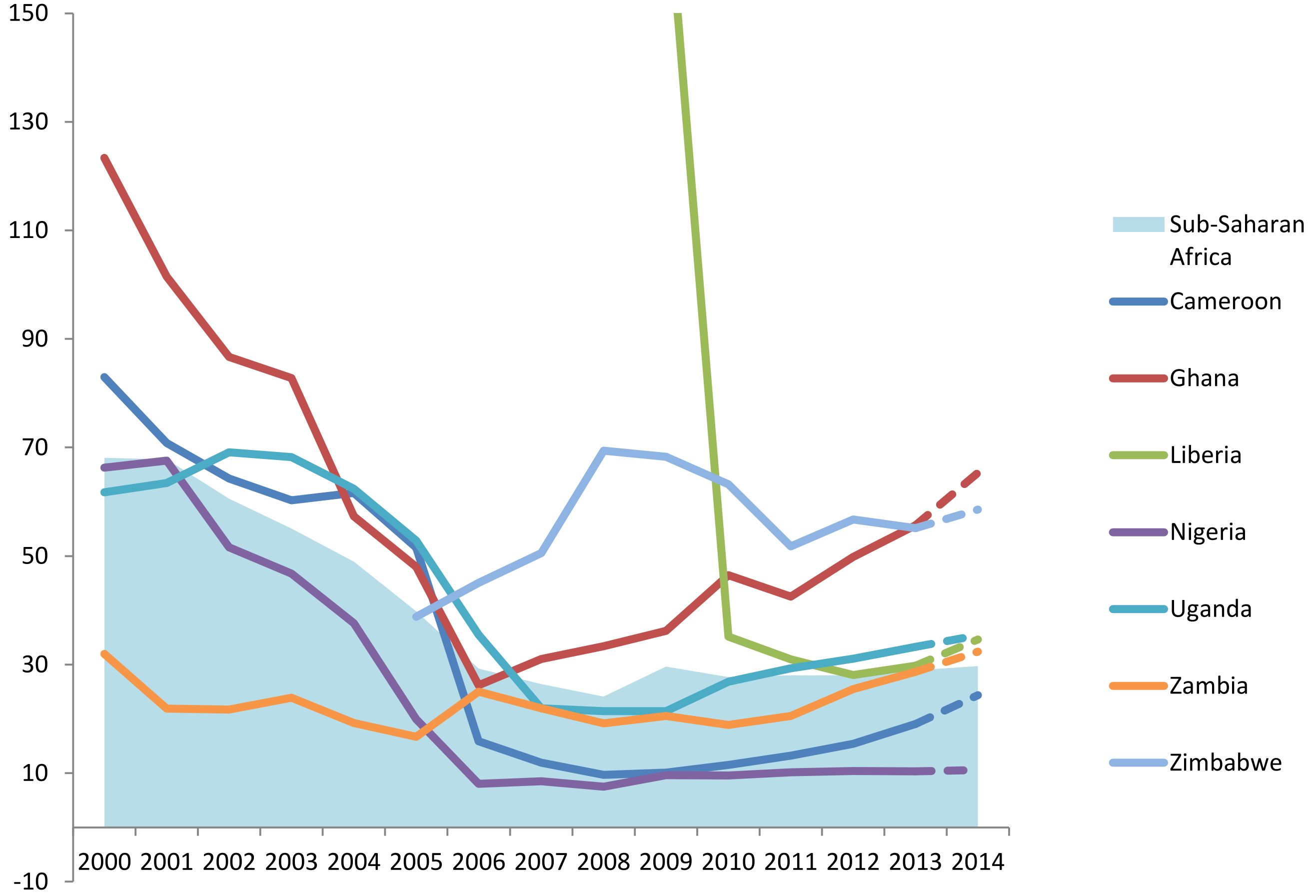
- China seems open to a Sovereign Debt Restructuring Mechanism-like statutory platform to ensure that future debt treatments are negotiated in the context of a standstill, respect inter-creditor equity and are binding.

- The Paris Club's 19 members should not continue to impose restructuring terms on other creditors based on the expectation of comparable treatment. Ratings agencies, analysts and other stakeholders should be engaged as participating observers in negotiations. But as the negotiating table expands, the tradition of operating on consensus will likely become unworkable and will need reform.

African Concerns and Interests

- African experts and policymakers have expressed great concern over the recent and sharp rise in government debt throughout the continent, and the consequent prospect of a new round of sovereign debt crises in Africa.
- Traditionally, African countries have borrowed mostly from multilateral lenders and the Paris Club. But African countries are increasingly turning to international capital markets and new bilateral lenders – China and other emerging market governments – for their borrowing needs.
- This means that the creditor-specific mechanisms used to facilitate past debt restructurings in Africa (Paris Club workouts, HIPC/MDRI, etc.) are fading in relevance and will be of diminished utility in the event of future debt crises.
- This situation gives African countries an interest in promoting and helping to build a new international framework for sovereign debt restructuring.

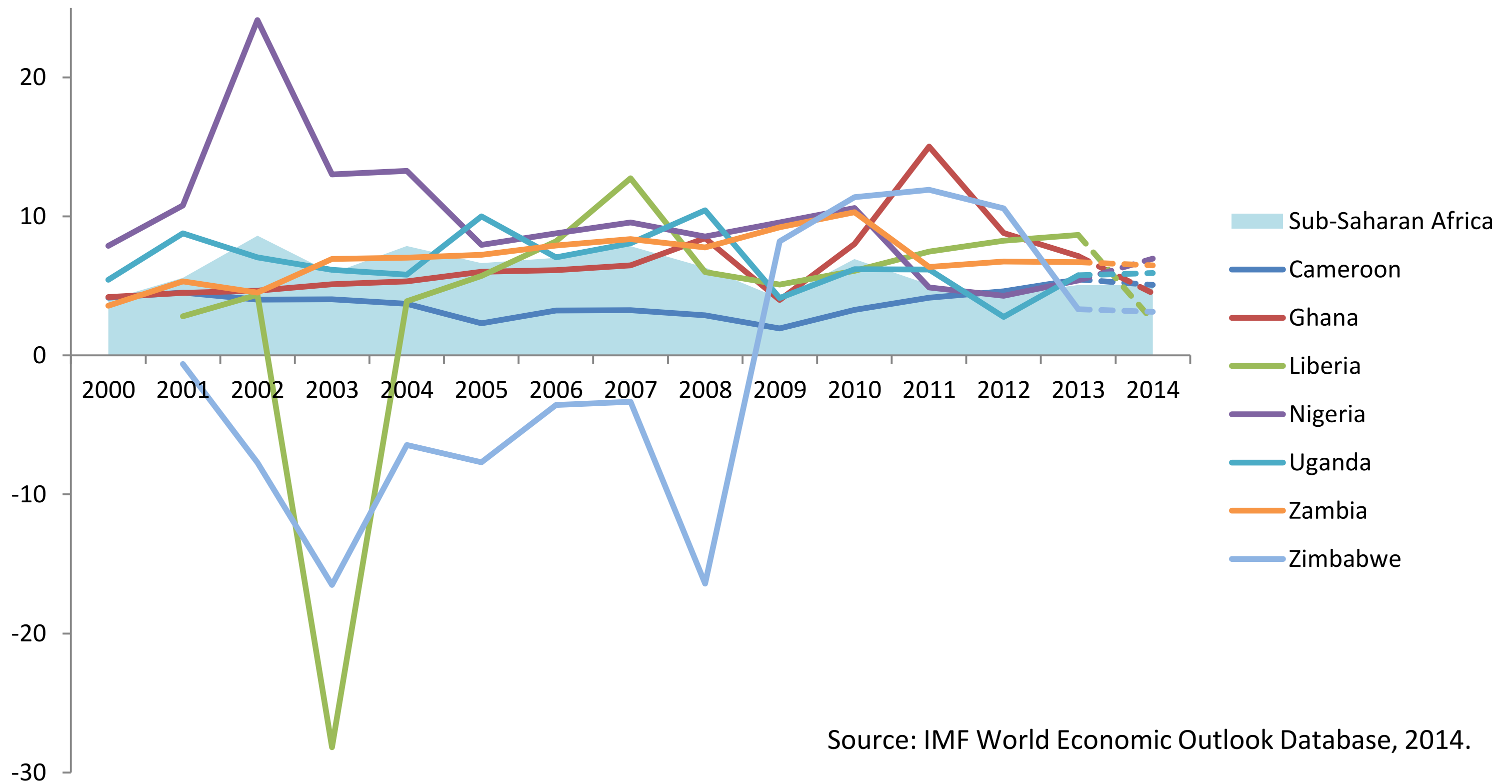
Debt-to-GDP (Africa)



Source: IMF World Economic Outlook Database, 2014.

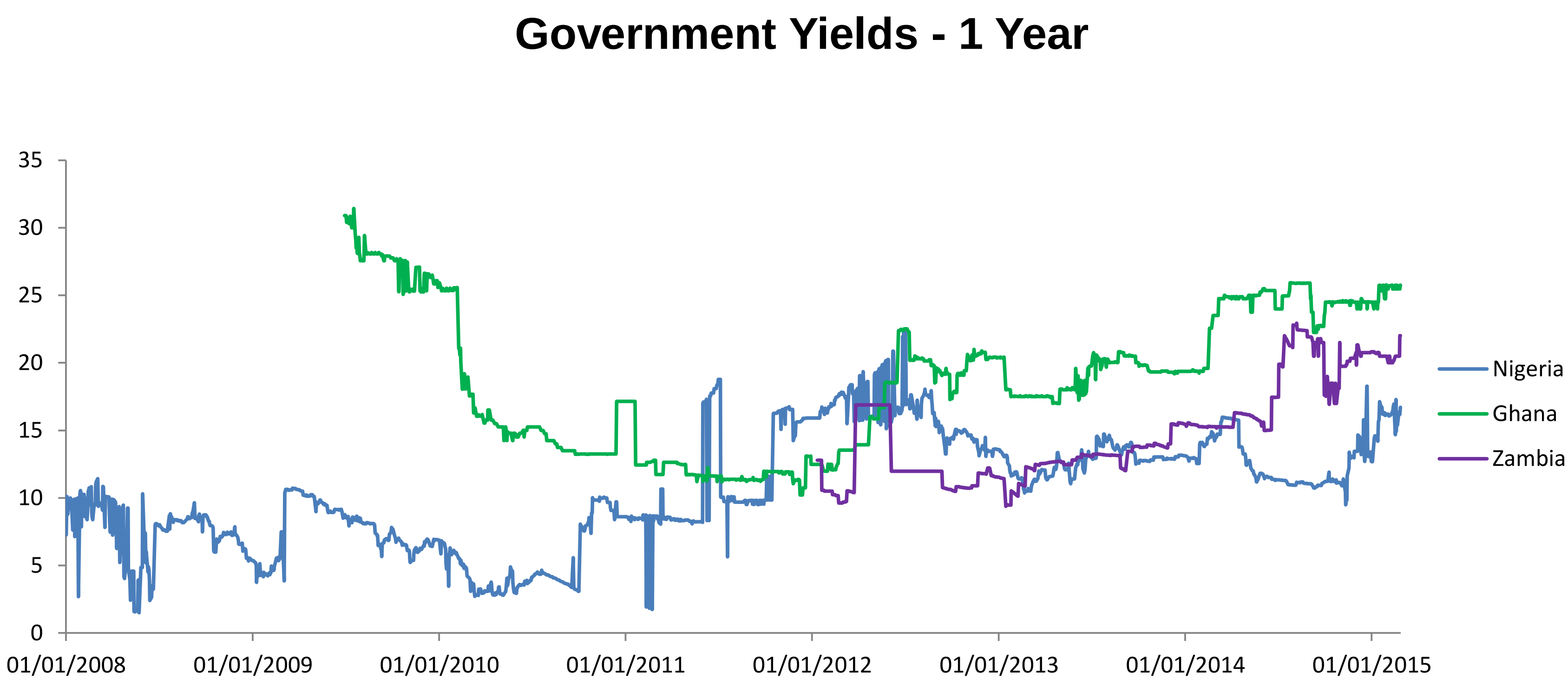
Ghana’s debt-to-GDP has risen the fastest, from 26% in 2006 to ~65% in 2014

GDP Growth (Africa)



GDP growth remains relatively strong, but recent history shows a susceptibility to dramatic shocks.

Borrowing Costs (Africa)



Source: Thomson-Reuters Datastream 2014.

Yields on government bonds have been trending upward since mid 2012

Downside Risks in Africa

- In 2013, the IMF noted that Africa's robust growth faced the *downside risks* of persistently weak demand in the Eurozone and negative shocks to private investment in the BRIC (Brazil, Russia, India, China) countries.
- As growth is stagnant in Europe and the US Federal Reserve continues to unwind its unconventional monetary policies, these risks remain prevalent.
- The IMF also warned in 2013 that some Sub-Saharan African countries were at "high risk of debt distress."
- Trends in debt-to-GDP, growth, and borrowing costs strongly suggest that the number of high risk SSA countries has only increased since then.
- And with the growing appetite for sovereign bond issuances, the IMF also warned of increasing currency risks. These risks remain especially high in the context of US Fed "tapering."

Mexican Perspectives

- Sound Debt Management Policies:
  - ✓ Duration (19.4 ys for external debt following emissions of 100-year bonds in GBP, $, EUR);
  - ✓ Diversified Investor Base (cultivating longer-term investors);
  - ✓ Domestic market (80%) to mitigate refinancing risk
- Lessons from 1980s debt crisis:
  - ✓ Bit-by-bit rescheduling in the 1980s did little to relieve debt problems in the context of regional crisis perpetuating a vicious cycle of indebtedness → lessons for IMF as length of rescheduling is context-specific
  - ✓ Importance of “vision” to re-access capital markets following restructuring

Inter-Creditor Equity Issues

- Much analysis focuses on distributional conflict between sovereign debtors and their creditors. In reality, there is considerable diversity among creditors that can have divergent or even conflictive interests.
- Many investors use SCDSs to hedge against the risk of default, others speculate on it and are generally interested in a credit event to happen → no requirement to disclose their underlying positions in SCDSs when they sit at the negotiating table.
- SCDSs dampen incentives for early restructuring. Moreover, holdouts with large SCDS positions could sue for repayment and, if successful, cash in twice.
- In 2011, EU banned speculative purchases of SCDSs but much of speculative activity migrated elsewhere.

Conclusions

- Despite the wealth of proposals, the international community has two broad (non-mutually exclusive) choices, besides maintaining the status quo:

1. ***Increase the IMF's financial firepower for bailouts***
2. ***Reform the arrangements that govern sovereign debt (modular vs big-bang approach)***

- While these choices are bound to reflect political interests and priorities, Latin American countries can play a very active and critical role in shaping these interests and priorities and thus the way forward.

- Bookmark this page to follow CIGI research on sov. debt restruct.: https://www.cigionline.org/thematic/management-of-severe-sovereign-debt-crises

THANK YOU!