

Round table discussion organized by the Center for Studies in Financial Innovation (CSFI) and the UN Financing for Development Office

New Policy options for dealing with sovereign debt problems: Discussion on recent initiatives

Panelists: Benu Schneider (UN-FFDO), David Lubin (Citigroup), Richard Segal (Knight Libertas), Philip Wood (Allen and Ovary), Lionel Price (former Fitch Ratings)

The issue of sovereign debt is important and contentious: this round-table meeting is part of a multi-stakeholder process, initiated by the UN, to hear views across the board and to get the debate going.

Benu Schneider introduced the discussion, reporting that sovereign debt issues have been at the centre of many of the general assembly issues at the UN. It has been felt for a long time, especially after the Asian Financial Crises, that there are serious gaps in the financial architecture for restructuring debt. The Sovereign Debt Restructuring Mechanism (SDRM) - proposed by Ann Krueger and introduced in 2001 - failed; and after that, the only developments in markets were the collective action clauses. In the follow-up to the Monterrey Consensus Conference in Qatar in 2008, governments across the world agreed that there had to be some kind of legal predictability in debt restructuring. There has been much discussion between governments about the gaps in international financial architecture, and a general agreement that proposals need to be made within existing mechanisms. The G77 and China would like to see a new debt restructuring mechanism - perhaps not the SDRM, but some kind of mediation and arbitration mechanism.

The financial crisis has given increased emphasis to the discussion, exacerbating the need for policy action. This time round there are highly rated sovereigns at the epicentre of this crisis; in Greece, there has already been an unprecedented amount of intervention from the ECB, the EU and the IMF (predominantly to preserve the AAA rating of the French banking system.) But no one believes that the troubles in Greece have yet been resolved - growth is not going to rise faster than the rate of interest at which payments will have to be made, so there are sure to be problems down the line. Furthermore, it is not the only affected country: the fear is that there are many economies that will prove problematic in the near future, and a contagion effect could threaten international stability.

Is official intervention the only way to avert disaster? It is interesting to note that during the discussion of the SDRM, in the backdrop of the Asian Financial Crisis, much emphasis was placed on the role of the private sector in crisis prevention management. This time round, there have been no calls to the private sector to deal with the sovereign debt issue; it seems to be exclusively dealt with by the official sector. Does the private sector have a role? It is certainly in the interest of both debtors and creditors that the financial system remains stable. There seems to be a moral hazard problem with official

sector lending: perhaps private sector institutions do not mitigate their risks sufficiently because they are confident that the official sector will intervene to cover any losses.

Given the magnitude of the crisis, we can expect defaults in some countries - a rough estimate, looking at real rate of growth versus weighted real rate of interest, suggests that countries like Greece are particularly susceptible. This volume of debt in this crisis is of a proportion that we have not known before. Yet the lack of early warning signals from the IMF and the credit rating agencies about the scale of this disaster has suggested that our response thus far has been far from adequate - something clearly went wrong with the frameworks used to assess whether sovereign debt is unsustainable.

Some general questions to be touched upon over the course of the discussion were:

Can we design a comprehensive approach to deal with the sovereign debt problem that averts a disaster and doesn't threaten international financial stability?

The IMF's Article VIII 2(b) states that, should the IMF board, say, agree that a country should not pay off its foreign creditors, that decision is legally enforceable - a standstill or a restructuring of debt can be put in place. But this article has been interpreted in different ways in different countries. Is a universal application of article VIII 2(b) a solution, or are there other options on the table?

David Lubin asked about the parallels that can be drawn between the Latin American debt crisis in the 1980s and the current Eurozone crisis. The question is particularly pertinent, it was stressed, because the Latin American crisis produced a 'lost decade' - in 1980, Latin American GDP per capita was about 40% of that of developed countries; by 1990, it had fallen to 28%.

1) The distinction between a liquidity crisis and a solvency crisis is very cloudy.

In the early 1980s, the dominant analysis suggested that Latin American countries were suffering from a liquidity crisis - but it is uncertainty about sovereign insolvency that creates liquidity problems to begin with. The process of going from a liquidity to a solvency crisis was facilitated by three issues: the fact that international capital markets remained closed to Latin America; inadequate policy making in some Latin American countries; and the relative weakness of the external environment. These factors will be decisive in determining how long the Eurozone crisis lasts.

2) The cost of dealing with an insolvency problem. Even by 1985/6, when the Latin American problem was being correctly analysed, the world was still not in a position to deal with it. Why? Because the only solution for a country with a solvency problem is to reduce debt - but in the 1980s, the Latin America bank creditors were so exposed to Latin America that they simply couldn't afford to absorb the costs of the write off. The nine US money-centred banks had 46 billion US dollars of loans outstanding to Latin America - 160% of their capital base. It was not until the end of the decade that issue could be properly resolved: the Brady Plan created a mechanism in which banks reduced the

nominal value of their claims on Latin American countries, in exchange for which the principle for these claims was collateralised by US treasury bonds. Perhaps collateralised debt reduction will regain some relevance in the context of the Eurozone debate - the beauty of the Brady Plan (despite its flaws) was that, because it gave collateral to creditors, it eased the pain of write offs.

Despite the fact that debt crisis management in the 1980s took ten years to resolve, we now often look the era as one of 'simplicity'. It was an era of commercial bank debt, where a country may have had, at most, a thousand creditors represented at a negotiating table by, say, a dozen large banks. Compare that to the 1990s, when developing countries got access to international bond markets - with a much more heterogeneous creditor group, the coordination problems of restructuring debt were more complex. That complexity cumulated in a couple of very messy sovereign debt restructurings, in Argentina and Ecuador (because, for example, the whole process could be held to ransom by a vulture fund.)

It was the messiness of debt crisis management in the 1990s that gave rise to the idea of creating a rules based framework. The SDRM - the most formal attempt that anyone has yet made to impose a rule based predictable framework for the management of sovereign debt issues - was given birth to in 2001, with the aim of achieving:

- 1) Supermajority voting - making collective action clauses an absolutely predictable, constant feature of international bond documentation
- 2) A mechanism to deter litigation - so a creditor that successfully sued a country couldn't end up better off than any other creditors.

But by 2003 the SDRM had been killed off: the Bush administration didn't like it because it overly constrained behaviour; creditors felt that rules-based mechanism would shift the balance of power towards debtors; and emerging market borrowers didn't like the mechanism because they felt it would increase the cost of accessing capital markets.

It is important to understand why the SDRM failed because we're likely to enter a more visible debate about the creation of a rules-based mechanism for the Eurozone:

- 1) The SDRM was perceived to be a violent and unpleasant erosion of sovereignty (this may not be such a big issue in the EU, because that's part of the 'deal' of EU membership)
- 2) It was very difficult, during the debate about creating the SDRM, to imagine who would be responsible for policing it (the obvious answer would have been the IMF, but since the IMF was a creditor, and not a disinterested party, it wasn't immediately trusted). Without a policeman, there was no way to credibly create and enforce sanctions. Again, in the EU context, this might be an easier issue to resolve - naturally, the policemen here are the European authorities.

The speaker finished by noting that the most effective way of dealing with sovereign debt crises may be to make the process 'messy', because the messiness of the process, and the uncertainty that goes with that, helps to create debtor discipline. If you create rules that facilitate the restructuring of debt, you might end up creating more restructuring than would otherwise be necessary. There is at least one widely quoted example of the market doing the job properly: in 2003, Uruguay, on a voluntary basis, negotiated with its creditors and achieved net present value reductions in its obligations without a lot of chaos.

Richard Segal began by asking: what are the core problems in Greece? Obviously, debt is too high - but there are fundamental structural problems: savings rates have been much too low; the public sector has been too bloated; pensions are much too generous, there has been resistance to privatisation; the economy is too rigid, notably in the service sector and tourism area; and statistical compilation methodologies have completely lacked credibility. The EU authorities have been aware of all these problems - including the off balance sheet transactions that took place in 2003 - but swept them under the carpet. Greece's public debt, as of the end of 2009 is 115%; if we assert that the country is insolvent today, it was probably insolvent ten years ago, when debt was 105% of GDP. And so, while Greece can reduce debt without structural reform, that approach won't create a prosperous country; nor will it mitigate the risk of a debt crisis arising again. It'd be wise to focus on forcing Greece to implement structure reforms immediately, and concentrate less on whether there is a need to restructure debt for now - that is a problem to be confronted two or three years down the road.

Should the public sector or private sector be funding this possible resuscitation of the Greek economy? Some observers have argued that, because of its past economic irresponsibility, Greece does not deserve public sector help. But it is worth noting that taxpayer-funded bailouts are win-win if the host country's fiscal mentality changes, and win-lose if the mentality does not change - the taxpayer is always repaid at par.

There are certainly lessons we can learn from the collapse of Lehman Brothers in 2008. With retrospect, the cost of the decision not to save Lehman - in terms of, amongst other things, the cost in lost output, the cost of saving the banks and the cost of unemployment - has been too high. In lieu of the preferential treatment given to institutions like AIG and Fannie Mae & Freddie Mac, it seems clear that we need to create a level playing field, with clear and consistent game rules. In certain situations, bail-outs are indeed advisable. What is important is that they're made for the right reasons - it is striking that emails from key figures in the US Treasury made clear that central to the decision not to save Lehman was a fear of criticism in the press. Looking at real emerging market bailout attempts over the last 10-15 years, the ones that succeeded were where there was political responsibility and accountably taken; for those that failed - consider Argentina and Russia a responsibility was really quite lacking. Ultimately, the key to preventing debt crises in the future is to recognise that debt reduction alone is not sufficient: the best cures are pre-emptiveness and moderation. We must ensure that there is strong risk management and real political accountability.

Philip Wood tried to introduce a sense of perspective, pointing out that more than half of the world's countries have been insolvent since 1980, and noting that Greece's insolvency is ultimately rather small when compared to some of the recent corporate insolvencies we've seen in the US. Nonetheless, the effect on people's lives and political stability means the seriousness of the situation in Greece should not be trivialised, especially if we consider the social ramifications of past debt crises in Argentina and Russia.

Do we have any precedents to help deal with the current situation? Looking at bank insolvencies, we have been here before - and state insolvency and bank insolvency are often intertwined, because of their sizes. So intense are the passions raised by dealing with the insolvency of banks, bankruptcy law has been nationalised in the UK: there is no creditor involvement and no judicial involvement, but rather, everything is run by the government via the FSA or the Bank of England. And perhaps that is prudent: in cases as extreme as insolvency, some system of autocratic despotism might indeed be necessary.

To get to the crux of the matter, we need to ask: what are the differences between the bankruptcy of the state and the bankruptcy of a corporation; what are the differences between the two systems of law; and, armed with that information, what are our options? Tighten up? Do nothing? Leave it to the market? Use just contracts? Have a full bankruptcy regime? It's interesting to note that if creditors want to get their way, it is in their interests to be anarchic - anything to do with the introduction of rules, according to this theory, ties them up and distorts the balance of power. Perhaps too often, people rush into clamouring for rules; yet the financial crisis started in countries - like the US and the UK - that have the most intense regulatory systems. Was the magic wand of the law partly responsible?

Lionel Price agreed that Greece can indeed undertake their fiscal adjustment, but argued that it is improbable that they will. While it might be perfectly rational for Greece to cut their fiscal deficit, the political difficulties are likely to prove insurmountable.

It was also noted that the rating agencies have Greece at around a triple B minus level, putting the probability of default over a 5 to 10 year horizon at about 10% - far less than is implied by market spreads. Why do people want higher spreads? It is largely due to the uncertainty, and messiness, of the debt restructuring process ideally, we should be trying to reduce this uncertainty. There have already been moves in this direction: first of all, collective action laws have spread from English law to New York law; second, we're seeing better information availability from debtors to creditors; and third, authorities have tried to reduce the chance of hold-outs by minority debtors - including vulture funds (though this hasn't yet proved particularly successful.)

The speakers' arguments raised a number of points of discussion. In response to an earlier point, one speaker asserted that the recovery rate on distressed bonds has been very high in emerging markets - but, if there is to be a recovery of distressed bonds in Europe, the evidence indicates that recovery rates will probably be noticeably lower. Of course structural reform in Greece should be encouraged, but since it will be so difficult to implement politically, the official intervention option must be combined with other

instruments - debt reduction being one of them. We must be practical and look at the reality of the situation: that politically, it is not possible for Greece to do what the world expects it do.

On this issue of practicality, one attendee noted that it is in the interest of medium and large private sector creditors to favour collective action clauses - simply because it avoids the need to get tangled in the web of international politics. It is difficult, as a private sector institution, to have noticeable influence when a body like the UN or a large country are involved; it's much easier to 'shelter behind' an established framework.

Another attendee re-ignited the 'rules versus chaos' debate. One lesson from the past, it was argued, is that often in developing country debt crises, developing country policy makers gets to a point where it is in their own interest to behave badly. If you want to negotiate an amount of debt reduction with your creditors, you want the price of your debt to be as low as possible; the lower it is, the bigger the discount you can negotiate. This is a terrible way of abusing market signals, and thus a very good argument for some kind of rules-based mechanism. It is reminiscent of what happened in Ecuador, where the government announced in advance that they were going to default to drive down the price of debt, and then bought back the debt.

And what of the role of the official sector through the Paris Club? In the name of transparency, the Paris Club has been putting out the debts due to them on their website over the last two years. But Paris Club agreements do not have a legal basis - so debtors don't have a legal instrument in their hands by which they can go to other creditors and call for comparable treatment. In terms of debt restructuring and legal structures, there is a lot of ambiguity around the rules of the game where the official sector and private sector is concerned.

1) That chaos can be good - chaos deters debtors from pursuing the wrong policies and can encourage debtor discipline.

2) But - chaos will often be detrimental and potentially destructive. There is a mutual recognition that, at least to some extent, rules do need to be in place. Today's debate has predominantly been a creditor response; it is important that the UN is properly aware of the views coming from a debtor perspective too. Ultimately, the goal is to bring together all stakeholders, and identify the issues around which we can build a consensus and take incremental steps forward in policy making.