

Debt Restructuring: Lessons from Latin America



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The Latin America and Caribbean region has an unenviable history of debt restructurings. There have been over 25 restructurings in the last 35 years and nine since 2002².

The most important lesson Latin America and the Caribbean can teach Europe during these hard times is: the old continent needs a debt restructuring mechanism³. This would allow a faster resolution of Europe's debt problems; maintain greater discipline in Europe's fiscal affairs relative to a bail-out; result in a deeper reduction in debt relative to a voluntary restructuring; lead to a more equitable sharing of the pain among private creditors and in the long run would minimize the erosion of investor confidence.

The lack of a restructuring mechanism created a dichotomy in Latin America's dealings with investors. Uruguay and Jamaica are examples of countries that implemented market friendly restructurings; with no reductions in principal and longer maturities. Uruguay returned very quickly to international markets and Jamaica to its domestic market at lower interest rates⁴.

Other countries, including Argentina and Ecuador, adopted a more aggressive route. They have been unable to access international markets after they imposed deeper principal haircuts on investors.

Argentina is perhaps the most infamous case, the restructuring following several years after the crisis itself. The story is a long one but the policy vacuum at the end of 2001 and early 2002, and a set of decisions made in that context certainly contributed to making the crisis the worst in the country's history. The case also highlights the important role of the IMF. And while it is hard to construct counterfactuals, had there been an alternative for local policy makers and a better mechanism to maintain engagement around August of

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² On debt restructurings in LAC see the essay in IMF (2002), more detailed accounts of several cases are found in Sturzenegger and Zettelmeyer (2007) and see Reinhart and Rogoff (2009) for a more general treatment.

³ On the Sovereign Debt Restructuring Mechanism (SDRM) proposed 2001 see Krueger (2002) and Krueger and Hagan (2005).

⁴ On Uruguay see Steneri (2003) and on Jamaica see Alleyne (2011) and Abuelafia and Powell (forthcoming).

2001, when the IMF signed its last agreement with the country, most likely a better outcome would have resulted for both the country and bond holders⁵.

The current “system” for executing deals with significant haircuts exacerbates tensions between countries and creditors. It fuels a cat and mouse game between lawyers acting for the countries and those acting for loosely formed creditor committees and individual creditors.

The borrower tries to convince creditors to accept a set of options of lower value or threaten they will get nothing. Creditors try to force the best deal for them threatening to “hold out”. Holdouts try to attach assets of the borrower, disrupting trade or other transactions to force higher payments⁶.

In addition, some “vultures” lurk around, buying up the claims of those investors, who would rather exit than fight to save a few bucks. These vulture investors then intentionally try to block any deal, blackmailing the borrower into paying in full, or face the consequences of the whole thing falling apart.

Faced with limited choices, countries have tough decisions to make. A market friendly route might bring in a lot of creditors. But the question is whether such deals do enough in terms of bringing down the present value of the debt to really solve the problem⁷.

Uruguay has been highly innovative in issuing new bonds with clauses that facilitate restructurings under the current system, with Collective Action Clauses in contracts but also facilitating aggregation across bond issues. These will help to prevent holdouts and vultures in the future. They give the cat bigger claws but it is hard for a country to predict and plan for every possible contingency. Ultimately, the system still remains a cat and mouse game and these clauses are an adjustment to the game not a new panacea⁸.

If a country decides that the friendly route will not cut it, then a deeper haircut is inevitable. Creditors may then complain that the borrower is not acting in “good faith” or is “rogue,” shunning its debt for a long period of time.

⁵ On the Argentine crisis there is a wide literature. Cline (2003) provides a useful review. My own view is expressed in Powell (2002) which evaluates four theories of the crisis. Calvo et al (2003) and Hausmann and Velasco (2003) provide particular and contrasting views. Mussa (2005) provides yet another and an account of the relations between Argentina and the IMF including a characterization of the flawed August 2001 package. Arozamena and Powell (2005) present a game theoretic account of the interaction between a country and the IMF; the authors argue that the international financial architecture remains incomplete.

⁶ On the cat and mouse game that accompanies restructurings there are many examples; Beattie (2010) details that an investor obtained a novel ruling in the 1990s to attach government payments made through Euroclear, the clearing house in Brussels, the avenue was then closed off through a clarification in Belgian law; Mercopress (2011) discusses the continuing actions of hold-outs from the Argentine restructuring.

⁷ There are of course cases of relatively successful debt restructurings with significant haircuts outside of LAC; one often-cited case is that of Iraq where it is interesting to reflect that this was conducted in the context of significant US political involvement in the country - see Beattie (2010) for comment.

⁸ See Galvis and Saad (2004) for an interesting discussion of advances in collective action clauses including the Uruguay case.

In sum, the lack of a restructuring mechanism forces a bipolar view. Be friendly and risk not solving the problem or be tough and risk being branded a pariah.

Europe seems to be moving along the right path to avoid the problems faced by Latin America, edging towards an agreement that would include access to liquidity but at the cost of subjugating some sovereignty to a type of debt restructuring mechanism⁹.

But the devil is in the details, and this is not an easy machine to design. To work, the mechanism must have three overriding objectives: prevent a massive drop in investment or a run from government bonds or banks; fiscal adjustment to ensure a country's budget is sustainable; and an equitable part of the pain shared by private sector creditors.

Many tensions will appear in the overall design and some discretion will be required in execution, so institutional design will be as important as setting the rules¹⁰.

If Europe comes up with something that works, policymakers may yet decide the world should have a debt restructuring mechanism. The current system is really no system at all and Latin America has suffered as a result.

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⁹ For alternative journalistic accounts regarding the lessons for LAC for Europe see Davis (2011) and Krugman (2011).

¹⁰ See Bolton and Skeel (2004) on the institutional design for sovereign debt restructuring mechanisms.

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