

# Private Contractual Approaches to Sovereign Debt Resolution

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## Restructuring Sovereign Debt

- Can any one believe that the *status quo* is efficient?
- Just two examples of myriad inefficiencies surrounding the Argentine debt crisis
  - Argentina: hampered ability to transact with the rest of the world
  - USA: diversion of talent into rent-seeking litigation

## Why is Restructuring Debt a Problem? A Simple Example

- Borrower owes 10 to creditor  $C$  and 5 to creditor  $S$
- Borrower will or can pay only 9 now
- In some future period borrower will or can pay 12 if both creditors agree to restructure the loan
- Creditors' choices: Restructure  $R$  or hold out  $H$

## The Payoffs

<i>C</i> 's action \ <i>S</i> 's action	<i>R</i>	<i>H</i>
<i>R</i>	4, 8	5, 0
<i>H</i>	0, 9	3, 6

- The decentralized Nash equilibrium:  $H, H$ : The classic prisoner's dilemma

## A Market Solution?

- Say  $C$  offers to buy out  $S$  at price  $P$  and unilaterally restructures
- $C$  gets  $12 - P$  and  $S$  gets  $P$
- An improvement for both over the Nash equilibrium if:

$$12 - P > 6$$

$$P > 3$$

which can be true for any  $P$  between 3 and 6.

- Much room for haggling
- As a tough negotiator  $S$  might even get 6, more than it is owed
- What if there are 2000 creditors instead of 2?

# Bankruptcy

- For domestic debt (personal, corporate, and municipal) the time-honored solution
- Ann Krueger at the IMF: the SDRM
- U.S. Treasury opposition: A contractual approach is adequate

Is sovereign debt different or should we abolish domestic bankruptcy procedures?

## CACs

- Started to be incorporated in NY contracts after Argentina's 2001 default
- Why did it take so long?
- Currently CACs apply only to individual debt issues, easy to game

## Proposed Solutions

- single-limb aggregated CACs (SLACAC's)
- GDP-linked bonds
- Contingent Convertible Bonds (COCOs) tied, e.g., to IMF liquidity lending

- SLACAC's: across maturities and currencies, how and by whom?
- GDP linked bonds and COCOs
  - Do we really think we will anticipate all the relevant states of the world and what course of action is best in each?
  - The contingent outcomes in this case are affected by the actions of the parties in question, not exogenous events such as earthquakes

## Credit Default Swaps: A Private Sector Innovation

- What problem are CDSs solving?
- Who declares a default? ISDA board members with CDS positions

## What Could be Done in Advance?

- A debt registry
- Efficient punishment for default: A repayment escrow account

What is politically feasible and what does economic analysis tell us to do?