

Sovereign default and state-contingent debt

Conference on “Frameworks for Sovereign Debt Restructuring”



Joint with the Bank of England

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Motivation

- Very high costs of sovereign debt crises
- IMF assessment of debt restructurings: ‘too little, too late’

Current crisis response playbook raises concerns

- Response to crises has been liquidity support from the international community
- There are concerns
 - Moral hazard and gambling for redemption
 - Incentivises short-term lending
 - Taxpayer resources and burden sharing
 - Write-downs harder to negotiate

Proposal for sovereign cocos

- Maturity extension of 3 years activated when sovereign receives emergency liquidity assistance from official sector
- Coverage: all sovereign-guaranteed debt (excl T-bills)
- Coupon payments maintained at original level and frequency
- Can only activate any given coco clause once

Some pros and cons

- Addresses liquidity crises; buys time to address solvency crises
- Improved burden-sharing of private sector creditors
- Reduce size of official sector support
- Enhances market discipline vs increase likelihood of crisis?
- Would they be triggered more than needed?

GDP-linked bonds

- Targeted on reducing solvency risks
- Another contractual adaptation of sovereign bonds
- Shiller proposal:
 - Bond principal indexed to nominal GDP
 - Bond coupon paid as a fixed proportion of the principal and so also varies with GDP
- Reduces risks to solvency from growth shocks

Why haven't these innovations been adopted?

- Misreporting of GDP, data revisions
- Natural conservatism of DMOs and fear of higher borrowing costs
- Concerns about market illiquidity – first-mover problem
- Concerns about valuation?

Some of these problems could be overcome through international coordination – lesson from CACs

Discussion

