Sovereign Debt Restructuring

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Countries (firms, households) often get overindebted

- Long history
- Long understanding that for efficiency reasons and for "moral" reasons it is important to give a fresh start
  - Especially true for sovereign debt
  - Where those who may suffer bear little relationship to those who borrowed
    - Previous government
    - Sometimes previous government was not even democratically chosen

Lender incentives

- Imposing some burdens (haircuts) on creditors has important incentive effects
  - Due diligence
- Especially important because of perverse political economy and corporate governance deficiencies
  - Those who gain from a bad loan are different from those who bear consequences
- Difficult to put appropriate checks on governments
- Financial sector actually encourages countries to borrow
  - Lending institutions have better grasp of risks—that is their expertise

Private borrowing

- Further problems posed by frequent shifting of private liabilities to the public sector
  - In an attempt to avoid accountability for bad lending
- Sometimes this is done explicitly
- Other times as a result of bankruptcy of government insured or too big to fail banks

Huge costs to sovereign debt crises

- Large macro-economic externalities associated with borrowing that private parties fail to take into account
- Especially in foreign exchange
- And especially when government takes over liabilities

puzzles

- Economic resources of the country are same before and after crisis
  - Output shouldn't be lower
  - Possibly even higher, as a result of eliminating the distortions leading to crisis
- Misallocation of capital should effect level of income, not full employment
- Recovery should be quick—yet downturns persist
- Debt shouldn't be a problem—internal debt: people just owe it to themselves; external debt: just lowers standard of living, not prevent full employment, high GDP (GNP lower than GDP)
- But debt is a problem:
- Given market failures and political economy problems, less room for government to stimulate
  - Likely to lead to high levels of unemployment
  - Even worse: creditors use power in other ways that have adverse effects on society
    - Interference in political process
    - Imposition of "reforms" in creditors' interests
    - End of democracy

Key Lessons from Economic Theory

- Markets are neither efficient nor stable
- No presumption that private bargaining is either efficient or fair
  - Quite the contrary
- Response to a gap in aggregate demand may exacerbate the problem
  - Especially when the domestic firms are owned by foreigners—decrease in demand for non-traded goods

Implications for debt

- The only was to have a quick restoration to full utilization of resources is reducing the magnitude of debt relative to income
- Three ways
  - Inflation—when debt is denominated in dollars
    - But current economic frameworks rule this out
  - Growth
    - But highly indebted countries don’t have access to funds
    - And scope for reallocating existing budgets is limited

    And supply side responses take time and in the short run are typically counterproductive

Debt restructuring only alternative

- The only alternative is to debt restructuring, reprofiling
- More funds to spend to stimulate the economy with multiplier benefts
- Benefits even greater if money is spent on investments
- Gdp linked bonds aligns incentives of borrower and lender

Failure of current arrangements

- Large inefficiencies associated with current arrangements
- Large inequities—power relationship
- Reasons that we need a domestic bankruptcy law are even stronger in the case of sovereign debt
- Ambiguities about claimants (formal and informal), “assets”
- Conflicting jurisdictions

Contract based approach can't work

- Asymmetries in bargaining power
  - Leading to dead weight losses and unfair resolutions, with adverse effects on the functioning of the entire sovereign debt market
- Difficulties in aggregation in collective action clauses
- With non transparent cds's no way of knowing whether parties are bargaining in good faith

- UN adopted set of principles governing sovereign debt
- Key principle: recognition of sovereign immunity
- No government can sign away this basic right
- Just as no individual can sign himself into slavery
- The contractual approach does not recognize this basic principle
- Current contractual approach deficient in other principles

Multiple Consequences: Finance for development

- Debt finance one important source of funds
- But current arrangements are an impediment to the functioning of debt markets
- Creating a framework for a “statutory approach” towards sovereign debt restructuring thus not only reduces dead weight losses and inequities associated with current framework, but will have benefits for the long run running of debt markets