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

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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 asses 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 payoff its foreign creditors, that decision is legally enforceable - a standstill or a restructuring of debt can be put in place.

nominal value of their claims on Latin American countries, in exchange for which the principle for these claims was collaterals 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 heterogonous 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 lease 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.

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