

Fixing Sovereign Debt Restructuring

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- ① The objectives of debt restructuring
- ② The current situation
- ③ The Contractual Approach response and its limitations
- ④ Framework for Sovereign Debt Restructuring

- Bankruptcy has a central role in modern capitalist economies
 - Hard to imagine a modern economy without limited liability and the possibility of debt restructuring
- Both efficiency and equity dictate a fresh start
 - As a result of excess indebtedness, there is a massive waste of resources
 - Resources before the crisis are the same as after
 - Debt is just an obligation
 - The problem is that there is an “excess” of claims
 - Disputes over how to satisfy excessive claims destroys resources
 - And have systemic effects

- Private outcome is likely to be Pareto inferior
 - Market equilibrium characterized by failures (coordination, bargaining, signaling)
 - Part of the explanation for existence of domestic bankruptcy laws
- A system of orderly discharge of debts would lead to more efficient use of resources in the present

- Bankruptcy regime attempts to balance
 - Ex-post efficiency
 - Ex-ante efficiency (credit assessment, risk-taking)
 - Efficiency in the restructuring process
 - Excessive penalties would induce delays

- But there is no international bankruptcy law
- “Too little, too late” syndrome
- Judge Thomas Griesa ruling in Argentina’s case makes debt restructuring *de facto* impossible
 - Creates both inefficiencies and inequities in global financial markets
- Remedies on the table:
 - Improvements within the private contractual approach
 - A multinational framework for sovereign debt restructuring

- CAC and Pari Passu
 - Improvements over the old terms
 - But not sufficient to solve the current problems
- Limitations:
 - Do not solve the problem for the existing debt stock
 - Multiple inter-creditor equity problems
 - Coordination problems

- Problems for determining priority with debt issued in different jurisdictions
- Problems of determining valuations with debt issued in different currencies

- The backgrounds of the negotiations are biased against the “implicit creditors” (workers, pensioners)
- IMF bailout policies favor short-term creditors and hurt long-term creditors, including the implicit creditors

- With heterogeneous debtors and imperfect information, the market solution leads to a suboptimal signaling equilibrium
- Makes demand for “tough” jurisdictions inelastic

- Full disclosure of SCDSs
- Variants of champerty into contracts
- GDP indexed bonds

- Must recognize the limitations of the market-based approach
- Must provide the conditions for timely restructurings
- Must be aware of the minimum set of principles over which the parties involved would agree on

- 1 Sovereign initiates the restructuring
- 2 System should incentivize no delays
 - Stays for litigation
 - Lending into arrears
- 3 Stage of possible objections by other parties
 - Alternative proposals must justify how they recreate the conditions for sustained growth (instead of just re-creating conditions for repayment in the short-term)
 - Proposal should describe the impacts on all stakeholders

- ④ End of the process depends on type of mechanism: Hard law vs. Soft law
 - **Hard law:** An International Bankruptcy Court would require that countries that adhere to the mechanism sacrifice sovereign immunity
 - And would be associated with complex geopolitical problems
 - **Soft law:** An Oversight Commission (composed by other States that endorse the Multilateral Framework) would act as a supervisor and mediator
 - It would not have the capacity to rule over the final proposal, but could make statements on its reasonableness
 - Therefore, it would legitimate the outcome of the restructuring process

- SDR nowadays featured by lengthy and intricate negotiations
- Conditions apt for emergence of destabilizing vulture funds, with systemic implications
- Recent evolution of legal frameworks played in favor of the vultures's business, not in favor of global social welfare
- Space for improving contracts, legal frameworks, and IMF bailout policies

- But with incomplete contracts the private contractual approach will not suffice
- Calls for a formal framework for SDR
- A more efficient restructuring process could lead to lower interest rates
- “Soft law” under discussion at the UN
- Absence of formal frameworks will imply still further problems in SDR of the type described in this presentation