Fixing Sovereign Debt Restructurings[1]

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Abstract

Recent controversies in sovereign debt restructurings show the weaknesses of the current market-based system for achieving efficient and fair solutions to sovereign debt crises. This article reviews the existing problems and proposes solutions. It argues that improvements in the language of contracts, although beneficial, cannot provide a comprehensive, efficient, and equitable solution to the problems faced in restructurings—but there are improvements within the contractual approach that should be implemented. Ultimately, the contractual approach must be complemented by a multinational legal framework that facilitates restructurings based on principles of efficiency and equity. Given the current geopolitical constraints, in the short-run we advocate for the implementation of a "soft law" approach, built on the recognition of the limitations of the private contractual approach and on set of principles over which there may be consensus, as the restoration of sovereign immunity. The framework could be adopted by the United Nations, or it could require the creation of a new institution.

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1. Introduction

Debt matters. In recessions, high uncertainty discourages private spending, weakening demand. Resolving the problem of insufficient demand requires expansionary macroeconomic policies. But "excessive" public debt constrains the capacity for running expansionary policies.[4] Thus, it impedes economic recovery.

Even if programs of temporary assistance make it possible, full repayment in those situations would only make matters worse. It would aggravate the economic situation of the debtor and would create large inter-creditor inequities, as only the creditors that get paid with the resources of the temporary assistance would benefit, while the expected value of medium and long-run claims would be decreased.

Distressed debtors need a fresh start, not just temporary assistances. This is in the best interest of the debtor and the majority of its creditors: The impossibility of a rapid fresh start for the debtor leads to large negative sum games, where the debtor cannot recover and creditors cannot benefit from the larger capacity of payment that the recovery would imply.

Lack of clarity for resolving debt crises could lead to chaos. There would be potentially extended periods of time during which the claims are not resolved, in which business cannot proceed—or at least proceed in the most desirable way—and in which assets may be tunneled out of the firm. Bankruptcy laws are designed to prevent this chaos, ensuring an orderly discharge of debts. They establish how restructuring will proceed, who will get paid first, what plans the debtor will implement, etc. Bankruptcies are typically resolved through bargaining among the claimants, but with the backdrop of a legal framework, and with a judiciary that will decide what each party will get, based on well-defined principles.

Bankruptcy laws protect corporations, domestic public entities, and their creditors, facilitating the processes of debt discharge. But there is no international bankruptcy comprehensive procedure to ensure proper resolution of sovereign debt crises. Instead, the current system for sovereign debt restructuring (SDR) features a decentralized market-based process, where the debtor engages in intricate and

[4] It is not high debt per se what is bad for economic growth, as careless studies that had been influential in the policy debate have suggested (Reinhart and Rogoff, 2010). Instead, it is the impossibility of running expansionary macro policies when primary surpluses are allocated to debt payments in times of recessions (which are indeed often associated with high debt) what makes debt a constrain for economic recovery.

complicated negotiations with many creditors, with different interests. Restructurings come *too little, too late*. And when they come, they may take *too long*.[5] The lack of a rule of law leads to ex-ante and ex-post inefficiencies, and inequities both among creditors and between the debtor and its creditors.

Furthermore, unlike domestic bankruptcies, sovereign bankruptcy negotiations take place in an ambiguous legal context. Several different jurisdictions, all with different perspectives, influence the process. Different legal orders generally reach different conclusions for the same problem. It may not be clear which will prevail, and how the implicit bargaining among different countries' judiciaries will be resolved.

At the time we write this article, events are making the fixing of the frameworks for SDR a major issue. The gaps in the legal and financial international architecture favor behaviors that severely distort the workings of sovereign lending markets. The emergence of vulture funds—investors that buy defaulted debt on the cheap and litigate against the sovereign, disrupting the whole restructuring process—is a symptom of a flawed market-based approach for debt crises' resolution. Recent decisions have also highlighted the previously noted interplay among multiple jurisdictions, none of which seems willing to cede the right to adjudicate restructuring to the others (Guzman and Stiglitz, 2015b).

There is consensus on the necessity of moving to a different framework, but there are different views on the table about how to move forward.

The IMF and the financial community represented by ICMA recognize that the current system does not work well (ICMA, 2014; IMF, 2014). They are proposing modifications in the language of contracts, as a better design of collective action clauses and clarification of *pari passu* —a standard contractual clause that is supposed to ensure fair treatment of different creditors. These proposals are improvements over the old terms, but they are still insufficient to solve the variety of problems faced in SDRs. And it is almost surely the case that new problems will arise—some anticipated, some not—within the new contractual arrangements.

On the other hand, a large group of countries is supporting the creation of a multinational legal framework, as reflected in Resolution 11542 of the General

[5] And when they do not take too long, they may not achieve the objectives of restructuring that we define in section 2. This is the case of the Greek debt restructuring in 2011. The deal was mostly a socialization of banks' debts that was not conducive to the recovery of the economy. Four years later, the country is still suffering from severe problems, with anemic output growth and an unemployment rate above 25% in January 2015 (as reported by Hellenic Statistical Authority - Labor Force Survey, 2015)

Assembly of the United Nations of September 2014.[6] The framework should complement contracts, putting in place mechanisms that would establish how to solve disputes fairly. Building it on a consensual basis will be essential for its success. This in turn requires fulfilling a set of principles over which the different parties involved would agree on, an issue that we analyze in this article.

The rest of the paper is organized as follows: Section 2 deals with the objectives of restructuring. Section 3 describes the current problems. Section 4 describes the solution proposed by ICMA and the IMF, and section 5 analyzes its limitations. Section 6 discusses a set of further reforms that could be implemented within the contractual approach. Section 7 outlines the principles that should guide the creation of a multinational formal framework for SDR. Section 8 concludes.

2. The objectives of restructuring

In absence of information asymmetries and contracting costs, risk-sharing (equity) contracts would be optimal; there would be no bankruptcy. But under imperfect information and costly state verification, complete risk sharing is suboptimal, and the optimal contract is a debt contract (Townsend, 1979).[7]

Information asymmetries and costly monitoring characterize the world of sovereign lending, which explains the widespread utilization of sovereign debt contracts. The optimal debt contract may be associated with partial risk sharing, including default in bad states and a compensation for default risk in the form of a higher (than the risk-free) interest rate in good states.

If default were never possible, the borrower would absorb all the risk. The lender's (who is compensated for the opportunity cost) expected utility would be the same, but the borrower's would be lower. Moreover, if the possibility of default were ruled out *in every state of nature*, the amount of lending would be severely limited.

[6] This is not the first attempt to implement a framework of this nature. The IMF had called for the implementation of a Sovereign Debt Restructuring Mechanism (Krueger, 2001; although the IMF Executive Board would have determined sustainability and judged on the adequacy of the debtor's economic policies) and the report of the International Commission of Experts of the International Monetary and Financial System appointed by the President of the General Assembly of the United Nations had pointed out the necessity of a exploring enhanced approaches for the restructuring of sovereign debt (Stiglitz, 2010).

[7] In private debt markets, other considerations relating to adverse selection and moral hazard also militate for at least some reliance on debt. See, e.g. Stiglitz (1985).

The probability of entering into situations of debt distress depends on a variety of economic conditions[8] but also on the actions of the debtor. And once the distress arises, further debtor's capacity of production and repayment will depend on how the debt situation is resolved. If the debtor defaults, she normally loses access to credit markets until a restructuring agreement is reached.

The mechanisms in place for debt restructuring determine how all these tensions are resolved. A good system should provide lenders and debtors with the incentives for behaviors that are conducive to efficiency ex-ante (i.e. at the moment of lending decisions) and ex-post (i.e. at the moment of resolving a debt crisis). It should also ensure a fair treatment of all the parties involved.

2.1. Efficiency issues

A system that makes restructurings too costly induces political leaders to postpone the reckoning. When there are no mechanisms in place that would ensure orderly restructurings, the perceived costs of default to the party in power become too large. Therefore, "gambling for resurrection" may be the optimal debtor's strategy. Delays are inefficient. They make recessions more persistent and decrease what is available for creditors if a default occurs. In the presence of cross-border contagion, furthermore, the delay is costly not only to the given country, but to those with which it has economic relations (Orszag and Stiglitz, 2002).

The objective of the restructuring must not be to maximize the flows of capital or to minimize short-term interest rates. Instead, the framework should ensure *overall economic efficiency,* a critical feature of which is *ex-post efficiency* in a broader sense: it should provide the conditions for a rapid and sustained economic recovery. A system of orderly discharge of debts would permit the debtor to make a more efficient use of its resources, which may be in the best interest both of the debtor and the creditors. Normally, one would expect contractual and judicial arrangement that support this kind of ex post efficiency that is necessary for achieving Pareto efficiency.

Another critical feature is *ex-ante efficiency*. A system that does not put any burden on the lenders ex-post does not provide the right incentives for due diligence ex-ante. Selection of "good" borrowers requires in general specific actions from the lenders, as screening (before lending) and monitoring (after lending). The existence of a

[8] Importantly, it also depends on the discrepancy between the expectations on the future capacity of repayment and the realizations that determine the actual capacity of repayment. See Guzman (2014).

mechanism for sovereign debt restructuring would act as a signal that money will be lost unless due diligence is applied

2.2. Equity issues

The framework for restructuring determines the incentives for creditors' behavior. A system that favors holdout behavior creates a perverse moral hazard problem. By increasing the incentives to holdout, it makes restructurings more difficult –in occasions, even impossible.

It also creates inter-debtor inequities, as it increases the borrowing costs for those debtors that are more likely to need a restructuring. Of course, debtors that are more likely to default should pay a higher interest rate. The problem is that if the restructuring mechanism is inefficient—as the current system is—it *over-penalizes* these borrowers, and the *ex post* inefficiency also gets translated into an *ex ante* inefficiency, as the unnecessarily high penalty discourages participation in the credit market.

3. The Current Problems

The vulture funds

Restructurings involve a public good problem: each claimant wants to enjoy the benefit of the country's ability to repay from debt reduction, but each wants to be repaid in full.

The existing frameworks fail to solve the public good problem. Instead, they provide the conditions for the emergence of vulture funds.

The vulture funds are a class of holdouts that are not really in the business of providing credit to countries. Instead, they are engaged in "legal arbitrage". Their business consists in buying debt in default (or about to be defaulted) in secondary markets at a fraction of their face value. Then, they litigate in courts, demanding full payment on the principal plus interest (interest that already included a compensation for default risk). A victory in courts brings exorbitant returns on the initial investment.

Their modus operandi relies on a legal framework that has debilitated sovereign immunity, and on a flawed design of contracts. They resort to activities (many of

which are socially unproductive) to increase their bargaining power and to influence the decisions of the actors involved—including lobbying and threats about economic and political consequences of a failure to reach a settlement satisfactory to the creditors (some liken it to extortion) to affect the debtor's behavior. Economic "extortion" is especially effective in influencing countries needing to reenter capital markets, and political extortion is especially effective to influence governments whose officials have been engaged in illegal activities or who are motivated by a concern over their "standing" in the international community.

Their presence creates huge inefficiencies and inequities in sovereign lending markets. It can even lead to the total impossibility of debt restructuring. Recent events—in particular, the Argentine debt restructuring, which pitted the country against NML Capital (a subsidiary of the hedge fund Elliott Management)—show that these inefficiencies are a major issue. In that case, the presiding U.S. federal judge, Thomas Griesa, ruled in favor of the vulture funds and ordered an injunction that obliged Argentina to make payments to vultures and the holders of bonds denominated in foreign currency issued by Argentina in the 2005 and 2010 debt exchanges on a *ratable* basis[9]—or otherwise any holder of exchange bonds would be barred from receiving payments. The injunction was based on a peculiar interpretation of *pari passu*, a contractual clause that is supposed to ensure equal treatment among equally ranked creditors.[10]

The design of contracts also facilitates the emergence of vulture funds. Many of the existing debt contracts do not have collective action clauses (CACs)—clauses that allow a majority of bondholders to agree to changes in bond terms (for example to reduce the value of the principal) that are legally binding to all the bondholders, including those who vote against the restructuring. Some contracts do include them but the majority is defined at the level of each individual bond.[11]

Under a unanimity rule, vulture funds can emerge easily. With CACs at the level of each security, vultures' behavior is more constrained but it is still possible. They can still buy the minimum fraction that would block the restructuring of a unique security, and by doing so they would be able to block the whole restructuring.

[9] As defined in the injunction, this interpretation of *pari passu* requires Argentina to pay to the vulture funds their full judgment whenever it makes any payment under the exchange bonds, even if it is just a coupon payment.
[10] The upshot is that vulture funds are poised to get about 1,600% returns on their "investments."
[11] In the 1990s, bonds issued in the London market under the English law contained CACs, while bonds issued in the New York market under the law of the state of New York did not (Eichengreen and Mody, 2003). Mexico was the first country to put these clauses in in its contracts under the jurisdiction of the state of New York in 2003.

A formula for aggregation of CACs (over different classes of bonds), as the one proposed by ICMA (see section 4), would *alleviate* these problems. But it raises others: how are different bonds to be added together for purposes of voting (how do we adjust for differences in priorities and exchange rates)? It is clearly conceivable that a majority of junior bonds could vote to deprive more senior bonds of some of the returns that they might have expected, given their seniority. There may even be ambiguity about which claimants should be included in the aggregation: only foreign, but also domestic.

Clearly, the issues faced in SDRs go beyond the design of CACs. These clauses are no panacea. If they were, there would be no need for bankruptcy laws that spell out issues like precedence and fair treatment. Evidence shows that no country has relied on the virtues of markets to solve bankruptcies. Theory also shows that under realistic conditions markets are not able to provide efficient restructurings on their own, as they are unable to reach efficient solutions on their own in general, except under very unlikely conditions (Greenwald and Stiglitz, 1986). There are important market failures that are present in restructurings –either for corporations or for sovereigns.

Debilitation of sovereign immunity and the Champerty defense

The evolution of the legal frameworks has been instrumental for the emergence of vultures and the debilitation of sovereign immunity. Sovereign immunity had firstly been challenged with the sanction of the Foreign Sovereign Immunity Act in 1976 (Schumacher, Trebesch, and Enderlein, 2014), and more recently by litigation over the champerty defense –an English common-law doctrine, later adopted by US state legislatures, that prohibited the purchase of debt with the intent of bringing a lawsuit (Blackman and Mukhi, 2010).

The case *Elliott Associates, LP v. Banco de la Nación and the Republic of Peru* was a game changer for the interpretation of legal frameworks affecting sovereign immunity. Elliott had bought Peruvian debt in default and sued the country for full payment in the New York courts. The US District Court for the Southern District of New York naturally ruled that champerty applied, dismissing Elliott's claims. But the Second Circuit of Appeals reversed the decision, stating that the plaintiff's intent in purchasing the Peruvian debt in default was to be paid in full or otherwise to sue. Then, according to the Second Circuit, Elliot's intent did not meet the champerty requirement because litigation was contingent. Such an interpretation is absurd, as it was not reasonable to expect to be paid in full over a promise that had already been

broken. The exorbitant returns obtained based on an interpretation that was unreasonable to expect constituted a case of "unjust enrichment" (see Guzman and Stiglitz, 2014c).

In 2004 the New York state legislature effectively eliminated the defense of champerty concerning any debt purchase above 500,000 US dollars. That decision constituted a change to the understanding over which hundreds of billions of dollars of debt had been issued, redefining property rights. This change in legislation ensured the good health of the vultures' business.

Distortive Credit Default Swaps (CDSs)

Sovereign debt restructuring problems are aggravated by the non-transparent use of CDSs. CDSs separate ownership from economic consequences: the seeming owner of a bond could even be better off in the event of a default, as the payments over the CDS would be activated in such event.

The opacity of this market makes unclear what the real interests are for those who have a seat at the bargaining table. This is another reason for delaying restructurings and creating inefficiencies.

The unbalanced background for negotiations

The legal frameworks and the bailout policies of the IMF determine the background of the negotiations (cf. Brooks, Guzman, Lombardi, and Stiglitz, 2015). The current arrangements favor short-term creditors against long-term creditors, including in the latter group the "informal creditors" (the citizens towards which the sovereign has obligations, such as workers and pensioners).

IMF bailout policies only aim at increasing the capacity of repayment in the short-run. In practice, they have not been designed with the purpose of favoring sustained economic recoveries. In occasions they even undermined them (both as a result of counterproductive conditionality and because of insufficiently deep restructuring), increasing the probability of a subsequent restructuring being needed down the road.

Political economy issues

SDR mechanisms must take political economy issues into account. The costs of restructuring are usually borne by different political actors than those who created

the problem. A system that makes restructurings too costly exacerbates political economy tensions, as it incentivizes debtors to delay the recognition of problems.

Creditors' behavior may also exacerbate these tensions, particularly when they provide short-term lending at high interest rates to countries that are obviously in need of a restructuring, taking into account the distorted incentives of the distressed debtors to recur to those funds, a "gambling for resurrection" behavior. Then, creditors should bear part of the responsibility for lending under such conditions.

4. The market-based approach response

The International Capital Market Association (ICMA), with the support of the IMF, proposes to resolve the failures in SDR by modifying the contracts' language. The new terms include a formula for aggregation of CACs and a clarification of the *pari passu* clause.

The formula for aggregation allows bondholders across different series of bonds to vote collectively in response to a restructuring proposal. The decisions of a supermajority (defined by acceptance of the aggregate principal amount of outstanding debt securities of all of the affected series) would be binding to all the bondholders across all series.

The clarification of *pari passu* establishes that, unlike Griesa's interpretation in Argentina's case, "*the Issuer shall have no obligation to effect equal or rateable payment(s) at any time"* with respect to any other External Indebtedness of the issuer, and in particular the issuer *"shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa"* (ICMA, 2014). In other words, ICMA states that *pari passu* does not mean what judge Griesa interpreted.

These new terms are improvements over the previous ones, but leave some important issues unaddressed—issues that we analyze in the next section.

5. Limitations of the private contractual approach: why a market-based approach will not suffice

Sovereign debt restructurings are more complex than private debt restructurings. They involve dealing with contracts issued under different terms, different jurisdictions, and different currencies, over which there may not be obvious ways for

comparing values when the contracts need to be rewritten. At those times, distributive conflicts will be magnified. The private contractual approach does not solve these issues according to efficiency or equity considerations, but on the basis bargaining forces. Outcomes are generally inefficient and inequitable.

The problem with existing contracts

The IMF estimates that roughly 30 percent of the $900 billion in outstanding bonds issued under the old terms will mature in more than 10 years. Approximately 20% of those stocks does not include any kind of CACs, and virtually all of the 80% that does include them, have CACs that operate only at the level of each security (IMF, 2014). What would prevent the current problems from arising if those debts had to be restructured? (Events especially likely to occur in the context of an anaemic global economy.)

Debt issued under the old terms could in principle be exchanged by securities that incorporate the new terms. But what would rule out holdout behavior if such a proposal is carried on? There is no solution to this quandary within the improved contractual approach.

Inter-creditor fairness

There are complicated bargaining problems among classes of creditors. A supermajority voting does not solve them all.

A simple supermajority rule could lead to a situation where junior creditors vote to have themselves treated equally with more senior creditors –and where they impose their position through a supermajority. This would make the senior status conditional to the outcome of the bargaining process. Indeed, if senior creditors were sufficiently small relative to the junior creditors, there is a presumption that their seniority would not be fully taken into account, and under the proposed arrangements, there is nothing they could do about it. Senior creditors would anticipate this possibility, and would react by demanding different contracts terms ex-ante (for instance, an early senior credit might limit the amount of junior creditor bonds that could be issued so as not to dilute voting interests, but that would have a deleterious effect on growth; alternatively, he could demand a higher interest rate).

When countries issue debt under different jurisdictions, establishing priority of claims could be a daunting task, with multiple contradictions. Contracts could become

inconsistent in crises times. For example, the terms of a bond issued under the jurisdiction A could state that the holder of that bond has priority over all the other claims. But at the same time another bond issued under the jurisdiction B could state the same. If it were not possible to satisfy both claims at the same time, how would priority be determined? Who would ultimately judge over it? It might be impossible to ensure the consistency of rulings from judges of different jurisdictions.[12]

The same bargaining problems may arise when a default is accompanied by a currency crisis, and the country issued debt under multiple currencies. How should debts that mature in the future be valued in the present in the event of a default? What nominal exchange rate should be used? The holders of debt denominated in a currency that is rapidly depreciating would claim for a strong exchange rate, while the holders of debt denominated in the other currencies would claim for the opposite, as everyone would attempt to maximize what they receive. It would be unfair to effectively deprive domestic bondholders of their voting rights in the event of a temporary currency crisis; and if that happened, opportunistic bondholders in foreign denominated bonds would have an incentive to seize the opportunity to effectively discriminate against the domestic bondholders.

Finally, how should the *informal claimants* (as workers and pensioners) be treated? Under collective action clauses, they would have no voting rights. A solution for this problem within the contractual approach is not easy. Governments could decide to give full creditor rights to social security claimants. But then, government agencies would be fiduciary for those claimants, which might "drown out" traditional creditors –an issue that would be anticipated and that would also be reflected in the interest rates.

Under a decentralized private contractual approach, solving this variety of issues would require intricate and lengthy negotiations, with complex legal questions, and would almost surely cast a pall of uncertainty over what might happen in the event of the need for a restructuring.

Signaling equilibrium

In the presence of imperfect information, debtors try to show that they are of a "good type" by using costly signals.

[12] See Guzman and Stiglitz (2015b) for a description of the interplay between legal jurisdictions in the case of Argentina's 2005 and 2010 restructuring.

In the context of sovereign debt, debtors may choose excessively "tough" jurisdictions to signal they are unlikely to default—jurisdictions that will make an eventual restructuring very difficult. Other debtors, by acting differently, would signal that they are more likely to restructure. Hence, the net payoff of deviating to a more reasonable jurisdiction would be negative. This is an inefficient global equilibrium.

Besides, bargaining models with imperfect information often engender delay as a costly signal, also leading to an inefficient global equilibrium.

6. Possible further improvements to the contractual approach

There are other modifications that could improve the workings of the market-based approach. They entail regulations to contracts, changes in domestic legislation, and the inclusion of clauses that make debt payments contingent on the economic situation of the debtor.

Regulation of Sovereign Credit Default Swaps (SCDSs)

CDSs have been advertised as helping to complete markets. But they have failed to do so, and instead have made matters worse.[13] The use of SCDSs distorts incentives.

SCDS distort incentives when they are used with insurance purposes (as noted above). But third parties can also demand SCDS for speculation purposes. This would not necessarily be a problem if there were no connections between the actions of the buyers and the interests of the sovereign. But the lack of transparency of these markets makes the connections possible (and profitable).[14]

To avoid conflicts of interest that could undermine the success of restructurings, and considering that the opacity of CDSs markets makes regulation too difficult, the

[13] Guzman and Stiglitz (2014a, 2015a) have shown that introducing these new instruments for betting may actually increase economic volatility and lower output permanently.

[14] The recent case of Argentine debt restructuring illustrates how perverse incentives can turn. In the aftermath of Judge Griesa's injunction that blocked the payments of the country to its bondholders, the International Swaps and Derivatives Association (ISDA) classified the credit event as a default. Interestingly, one of the members of ISDA committee was Elliot Management, the same vulture fund that was litigating against the country. (The debt contract only specified that Argentina turn over the requisite funds to the "agent"--which Argentina did. Argentine was thus not in breach of the contracts which it had signed in the process of restructuring. Indeed, Argentina had even warned investors in its contract of the possibility of these difficulties. That is why the so-called default has been labeled a Griesafault, to distinguish it from the normal default, where a party actually breaches a key contract provision. See Guzman and Stiglitz (2014b)).

purchase of SCDSs by third parties should be banned, and all CDSs owned by parties to the negotiations for debt restructuring should be made transparent.

Reinstating variants of the champerty defense

If investors that purchase debt in default were willing to settle under "reasonable" conditions, they would just provide a liquidity service in the markets for defaulted debt, and would thus contribute to avoid a larger depression in bonds prices in that state. But that is not what vulture funds do. Reinstating variants of the champerty defense (together with a clarification of the *pari passu* clause) would undermine the vultures' business, correcting inefficiencies.

GDP indexed bonds

With GDP indexed bonds, the principal is indexed to the nominal GDP of the country. The contingent element in the contract improves debt sustainability, as it makes debt obligations less burdensome when debt repayment is more difficult, and vice versa. Creditors also benefit from a lower probability of default.

These securities may also be an effective rule for sovereign debt restructuring. Exchanging fixed-coupon bonds by GDP indexed bonds would be the akin to a debt-equity swap. The inclusion of this contingency clause would also align the incentives of the debtor and the creditors, as each would benefit from the faster growth of the country.

Fiscal space would also increase. The numbers may be significant: Bank of England economists (Barr, Bush, and Pienkowski, 2014) estimate that GDP-linked bonds can increase fiscal space, defined as the difference between current debt ratios and the estimated debt limits, by around 45 percent of GDP (it must be noted, however, that "debt limit" is a subjective concept whose quantification requires taking a stance on the expectations about the government's capacity for generating revenues—a complicated issue over which it's relatively easy to make wrong assumptions, especially in the most volatile economies, that are the ones more likely to need restructurings).

7. A multinational legal framework for SDR

The majority of countries is advocating for institutionalizing a multinational statutory solution, as reflected in the Resolution 68/304 passed by the General Assembly of the United Nations on September 9, 2014.

Guidelines for the framework

The framework must recognize the limitations of the private contractual approach. It needs to solve the "too little, too late, too long" syndrome. It also needs to ensure a reasonably fair treatment of all parties.

Any framework for sovereign debt restructuring must take account of the primacy of the functions of the state, its obligations to its citizens, and the "social contract" the state has with its citizens (Stiglitz et al., 2015).

Although there are differences between sovereign debt and corporate debt restructurings, there are also important analogies. Thus, some of the provisions of chapters 9 and 11 of the US Bankruptcy Code should be considered (Stiglitz, 2002a).[15]

Deadlines. The sovereign should initiate the restructuring in a timely way. The framework should provide the right incentives for avoiding delays in the initiation and in the finalization of the restructuring. Therefore, it must set specific deadlines for the different stages of the process. This would make the whole process more predictable.

Lending into arrears. The framework must recognize the macroeconomic externalities associated with debt crises resolution. Thus, it should facilitate countercyclical macroeconomic policies. Provisions of lending into arrears, according to which creditors who lend while the restructuring process is being carried on would receive senior treatment, should be contemplated.

Stays. Litigation induces costly delays. It also creates a moral hazard problem, as it negatively affects creditors' incentives to enter into restructurings. Therefore, the framework should incorporate clauses of stays for litigation, which would prohibit

[15] Raffer (1990, 2015) explains that the essential points of the special insolvency procedure for municipalities in the US (Chapter 9, Title 11, USC) can be easily applied to sovereigns.

litigation in courts between the initiation and the finalization of the restructuring process.

Litigations could still occur in jurisdictions that do not endorse the framework, remaining a problem as a large proportion of debts will still be issued under those jurisdictions. However, judges of non-participating jurisdictions could consider the multinational framework as a reference on what is good practice in SDR.

Hard law vs. Soft law. The design of the framework must consider what is the set of principles over which all the parties involved would agree on. One possibility could be to follow a hard law approach, where countries adhere to an International Bankruptcy Court. If the rulings of the Court were enforceable, countries would be giving up on sovereign immunity. That might be unacceptable for many countries. Besides, geopolitical problems would be intense: How would the members of the international court be appointed? What interests would they represent?

Another possibility would be based on the restoration of sovereign immunity, but with the creation of a framework that would facilitate restructuring. This would occur through what might be called a "soft law" approach, with the creation of an Oversight Commission with the mission of mediating and supervising the restructuring process. The Commission would also maintain a registry of the debt stocks. The members of the Commission would be countries that endorse the multinational framework. The Commission would not rule over different alternatives. Instead, the sovereign would finalize the process with a final proposal and the Commission would produce statements about the reasonability of the process and the final proposal. This approach would serve to legitimate the restructuring, or alternatively, to legitimate positions that speak of illegitimate restructurings.

8. Conclusions

Restructuring is not a zero sum game. The mechanisms in place can have large effects on the overall economic performance. The existing institutional arrangements make the sum too negative, as they delay the initiation of restructurings, and lead to "solutions" that do not promote economic recovery—making recessions more severe and persistent overall. Deficiencies in the restructuring process get reflected too ex ante in the terms and volumes transacted in sovereign debt markets.

The world of debt restructuring needs to move to a different equilibrium. There is consensus on this necessity, but there are different views on how to move forward. On the one hand, the business community and the IMF advocate for tweaking the terms of contracts. Although the suggested new terms (aggregation of CACs and clarification of the *pari passu* clause) are improvements over the old terms (terms that clearly did not work), they still leave a legacy of problems unaddressed. There are further improvements that can be implemented, as we discussed in section 6.

But with incomplete contracts, even with all those improvements, a variety of problems will remain. In times of default, debt contracts will need to be rewritten. Under a market-based approach for restructurings, outcomes will be more determined by bargaining power than by considerations of efficiency and equity. Particularly disturbing is the fact that most countries that are entering debt restructurings are in a particularly weak position, and thus particularly vulnerable to pressure from creditors to agree to terms that are adverse to their long terms interests. And the knowledge that this is so gives rise itself to bad lending practices, especially in the context of the political economy problems we discussed earlier: creditors encourage more lending than is socially efficient, in the knowledge that they can use their market power to extract a favorable outcome for themselves in the event of a crisis. At least in the past, practices of the IMF, which provided funds to the government to bail out the *creditors* --ensuring that they were paid in full--only exacerbated the problem.[16]

A comprehensive solution requires the implementation of a statutory approach at the multinational level –an approach that “completes” contracts. The framework needs to address the limitations of the current approach. It needs to redefine the balance among the parties involved in the negotiation. It should be built respecting the principles over which the different actors involved would agree on, as possibly the restoration of sovereign immunity.

A "soft law" approach that entails a more active role for a quasi-judiciary can, we believe mitigate some, perhaps many, of the inefficiencies and inequities noted above. On the other hand, the absence of these mechanisms would still imply further problems for sovereign debt restructuring, and further barriers for recoveries of countries in recessions.

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[16] For a more extensive discussion of this problem, see Stiglitz (2002b).

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