Managing Sovereign Debt Sustainability Risks

Intergovernmental Group of Experts on *Financing for Development*

United Nations, Geneva

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- Undoing Quantitative Easing → Quantitative Tightening

96) Chart | 97) Set as Default View | Economic Forecasts

Country/Region/World | Contributor | Contributor Composite | Yearly | Quarterly

United States | Browse | Private | Official

Actual / Forecasts | Probability of Recession 15.0%

Indicator	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20
External Balance										
Curr. Acct. (% of GDP)	-2.3	-2.3	-2.2	-2.3	-2.4	-2.5	-2.5	-2.5	-2.6	-2.6
Financial Balances										
Budget (% of GDP)	-3.4	-3.7	-3.7	-3.8	-4.4	-4.7	-4.4	-4.7	-4.9	-5.0
Government Debt (% of GD..			76.9	77.1	77.2	77.7	77.7	78.3	79.3	79.9
Interest Rates										
Central Bank Rate (%)	1.50	1.75	2.00	2.25	2.50	2.70	2.90	3.05	3.10	3.05
3-Month Rate (%)	1.69	2.31	2.34	2.40	2.61	2.79	2.96	3.10	3.17	3.24
2-Year Note (%)	1.89	2.27	2.53	2.82	2.89	3.02	3.13	3.21	3.26	3.31
10-Year Note (%)	2.41	2.74	2.86	3.06	3.17	3.26	3.33	3.36	3.41	3.44
Exchange Rates										
EURUSD	1.20	1.23	1.17	1.16	1.15	1.18	1.20	1.22	1.25	

- Time of changes: political, technological
    - Bouts of volatility while learning takes place

- Incomplete contracts
- Written as non-contingent but contingent in practice
    - Debt payment capacity is stochastic
- No multinational legal system for resolving sovereign debt distress

- The standard anatomy:
  - Change in market expectations
  - Increase in the cost of debt rollover
  - Fiscal austerity and new loans (possible from official creditors) to meet larger debt payments
  - Lower economic growth, lower fiscal revenues, more debt distress

- **A note on the evidence:**
  - Alesina-Ardagna 2009, "Large Changes in Fiscal Policy: Taxes Versus Spending", analyzed 107 experiences of fiscal austerity and singled out 22 *successful* cases
  - Jayadev-Konczal 2010, "The Boom not the Slump: The Right Time for Austerity", analyzed how many of those
    1. happened in a recession
    2. were followed by a recovery of economic growth
    3. were followed by a fall in debt/GDP
  - The answer: only one case, Ireland 1987
    - Ireland's main trade partner was experiencing a boom at that time

- Eventually, there is a debt restructuring
    - "Too late", and often delivers "too little" relief

1970-2013: fraction of sovereign debt restructurings with private creditors followed by another restructuring or default with private creditors within t years

t	3	4	5	6	7
Fraction	0.497	0.525	0.553	0.575	0.6

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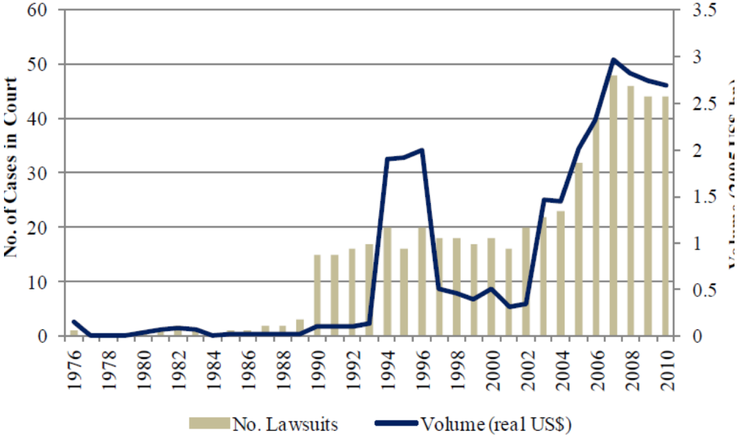
t	3	4	5	6	7
High Income	0.619	0.650	0.700	0.700	0.700
Upper Middle Income	0.500	0.548	0.578	0.590	0.622
Lower Middle Income	0.467	0.477	0.500	0.523	0.548
Low Income	0.455	0.455	0.469	0.531	0.548
Total	0.497	0.525	0.553	0.575	0.6

- Finalization of a restructuring process can take too long due to holdout/vulture funds behavior

Increasing litigation (Schumacher-Trebesch-Enderlein 2018 ECB WP)



- Deficient international financial architecture
- Domestic legislation
  - Punitive "compensatory interest rate" for missed payments (9% under NY law)
  - Legislation that favors vulture funds' business

- Domestic policies
  - International capital flows management
  - Choice of jurisdictions for debt issuance
- Larger-scale adoption of contingent debt (GDP growth bonds)
  - Important work from the Bank of England, Bank of Canada, Peterson Institute for International Economics
- Need for a multinational system for sovereign debt restructuring based on sound principles

- UN GA Resolution 69/319 (Sept 2015) adopted nine principles for sovereign debt restructuring:

    1. Sovereignty
    2. Good faith
    3. Transparency
    4. Impartiality
    5. Equitable treatment of creditors
    6. Sovereign immunity
    7. Legitimacy
    8. Sustainability
    9. (Super-)Majority restructuring

- Principles-based sovereign debt sustainability
  - Principles for sovereign debt restructuring impose additional constraints for defining debt sustainablity

- Deficient outcomes in the practice for sovereign debt restructuring
- Mounting risks
- Substantial room for improvement
    - Reforms to the international financial architecture
    - Better contracts
    - Management of international capital flows
    - Different approaches for assessing sovereign debt sustainability (principles-based)