Sovereign debt crises resolution: will this time be different?

12th UNCTAD Debt Management Conference
United Nations, Geneva

Martin Guzman (Columbia University & University of Buenos Aires)

November 19, 2019
Sovereign debt crises are back in some non-advanced economies

Recent decades: poor outcomes in sovereign debt restructuring processes

After Argentina’s 2002-2016 complex restructuring process: some reforms

- New contractual language → modern CACs and *pari passu* (suggested by ICMA and endorsed by the IMF)
- UN resolutions 68/304 and 69/319 for sovereign debt restructuring processes
Important feature of the current landscape: increasing social discontent

- Low tolerance to contractionary fiscal adjustments
- Visible social distress in some countries in South America with risk of contagion
- Argentina will (once again) test the architecture for sovereign debt crises resolution
Evidence on sovereign debt crises resolution

Alternative approaches for sovereign debt sustainability analyses and policies

The next big test for the architecture for sovereign debt crises resolution: Argentina 2020

- To what extent will the latest reforms help?
- What role will the IMF play?
Incomplete contracts

Written as non-contingent but contingent in practice

- Debt payment capacity is stochastic

- Debt service capacity may substantially differ from debt commitments

- Giving rising to situations of unsustainable debt burdens
What happens when sovereign debt distress arises?

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, more uncertainty
What happens when sovereign debt distress arises?

A note on the evidence:


- 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.
What happens when sovereign debt distress arises?

- Eventually, there is a debt restructuring
  - Generally *too late*, and often delivers *too little* relief
  - It only works if there is a shock of good luck (e.g. a boom in a trade partner or a positive terms of trade shock)
  - Otherwise, more distress and eventually another default or restructuring
1970-2013: fraction of sovereign debt restructurings with private creditors followed by another restructuring or default with private creditors within $t$ years

<table>
<thead>
<tr>
<th>$t$</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraction</td>
<td>0.497</td>
<td>0.525</td>
<td>0.553</td>
<td>0.575</td>
<td>0.6</td>
</tr>
</tbody>
</table>
What happens when sovereign debt distress arises: evidence on *too little* relief

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

<table>
<thead>
<tr>
<th></th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High Income</strong></td>
<td>0.619</td>
<td>0.650</td>
<td>0.700</td>
<td>0.700</td>
<td>0.700</td>
</tr>
<tr>
<td><strong>Upper Middle Income</strong></td>
<td>0.500</td>
<td>0.548</td>
<td>0.578</td>
<td>0.590</td>
<td>0.622</td>
</tr>
<tr>
<td><strong>Lower Middle Income</strong></td>
<td>0.467</td>
<td>0.477</td>
<td>0.500</td>
<td>0.523</td>
<td>0.548</td>
</tr>
<tr>
<td><strong>Low Income</strong></td>
<td>0.455</td>
<td>0.455</td>
<td>0.469</td>
<td>0.531</td>
<td>0.548</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>0.497</td>
<td>0.525</td>
<td>0.553</td>
<td>0.575</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Martin Guzman (Columbia University-UBA-CIGI)  
Sovereign debt crises resolution: will this time be different?
Finalization of a restructuring process can take too long due to holdout/vulture funds behavior
Increasing litigation (Schumacher-Trebesch-Enderlein 2018 ECB WP)

Sovereign debt crises resolution: will this time be different?
The roots of the problems

- Deficient international financial architecture
The elements of public debt sustainability analysis:

1. The relevant constraints for debt service capacity
2. The endogenous feedback effects associated with policies
3. The distributions of shocks
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 sustainability
The situation in a nutshell - Stage I:

- New economic regime from December 2015 brings change in access to credit markets and positive shock to market expectations

- Substantial fiscal deficits + tight inflation targeting (such that seignorage \(\ll\) fiscal deficit) \(\implies\) rapid increase in public debt

- Initially seen as sustainable under optimistic expectations
The next big test for the sovereign debt crises resolution architecture: Argentina 2020

The situation in a nutshell - Stage II:

- In April 2018, expectations change and a classic sudden stop occurs.
- Argentina and the IMF reach stand-by-agreement with record loan of US$57 bn.
- It comes with a macroeconomic program that features contractionary fiscal and monetary policies.
The next big test for the sovereign debt crises resolution architecture: Argentina 2020

- **The situation in a nutshell - Stage III:**
  - The economic situation deteriorates further
    - GDP falls for two consecutive years
    - The exchange rate ARG$/US$ went from 20 to 60 in 18 months (from April 20, 2018)
    - Unemployment rate > 10%
  - October 2019: the incumbent president, Mauricio Macri, loses the presidential elections, Alberto Fernández is elected as president
  - President elect Fernández will face the challenge of resolving the macroeconomic and social crisis
Forecasts vs. Reality, Argentina

Sovereign debt crises resolution: will this time be different?

Argentina: Real GDP and IMF projections
Index 2017=100
Reminds us of Greece (from Guzman-Heymann 2015, JGD)

Sovereign debt crises resolution: will this time be different?
The debt situation:

- No access to international credit markets (country risk $\approx 2500$ bps)
- No possible to meet scheduled debt payments under that condition
- The structure of bonded debt includes:
  - Foreign-currency denominated debt under NY law with modern CACs
  - Foreign-currency denominated debt under NY law with old CACs
  - Foreign-currency denominated debt under Argentine law without CACs
  - Local-currency denominated debt under Argentine law without CACs
Lessons from the theory and the evidence for the next big test for the sovereign debt crises resolution architecture – Argentina 2020

- Need to avoid *too late* problem to avoid falling into a destabilizing macro-debt dynamics

- Need to avoid *too little* problem to avoid falling into a destabilizing macro-debt dynamics

⇒

1. Restoring **debt sustainability** is necessary condition for **economic recovery**

2. **Economic recovery** is necessary condition for restoring **debt sustainability**
The next big test for the sovereign debt crises resolution architecture: Argentina

A possible path to restore debt sustainability:

- Reprofiling with private bondholders:
  - No debt service in 2020-2021 (extension of maturities and reprofiling of interest)
  - Convergence to primary fiscal surpluses and trade balances consistent with sustainable reprofiled debt at a speed that does not create destabilizing macroeconomic effects

- No IMF lending for meeting scheduled debt payments with private bondholders

- If there are any additional disbursements from the IMF, the funds should be used for investments oriented to the increase of production in the tradable sector

- Consistent with premise of improving public debt sustainability
A possible path to restore debt sustainability (continuation):

- Debtor negotiates in good faith

  ⇒
  - No debt default in December 2019
  - Proposal aligned with goal of restoring debt sustainability

- Deadline for achieving a successful reprofiling along these lines: March 2020

  - In order to avoid destabilizing macroeconomic effects
Will this time be different?