Sovereign debt crises resolution: will this time be different?

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- 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

1. Evidence on sovereign debt crises resolution
2. Alternative approaches for sovereign debt sustainability analyses and policies
3. 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

The standard anatomy:

- Change in market expectations

  $\Longrightarrow$ Increase in the cost of debt rollover

  $\Longrightarrow$ Fiscal austerity and new loans (possible from official creditors) to meet larger debt payments

  $\Longrightarrow$ Lower economic growth, lower fiscal revenues, more debt distress, more uncertainty

- **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
  - 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

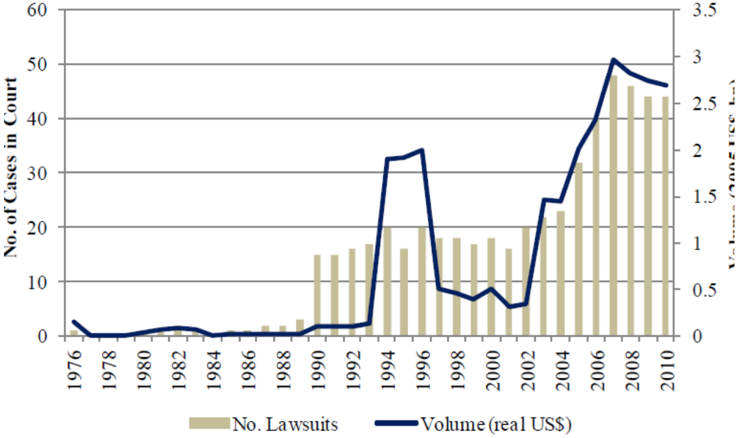
t	3	4	5	6	7
Fraction	0.497	0.525	0.553	0.575	0.6

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

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

- 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:

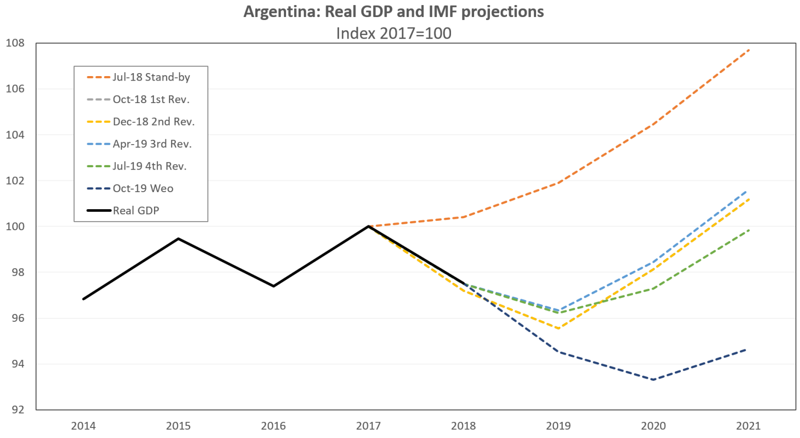
  1. Sovereignty
  2. Good faith
  3. Transparency
  4. Impartiality
  5. Equitable treatment of creditors
  6. Sovereign immunity
  7. Legitimacy
  8. Sustainability
  9. (Super-)Majority restructuring

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

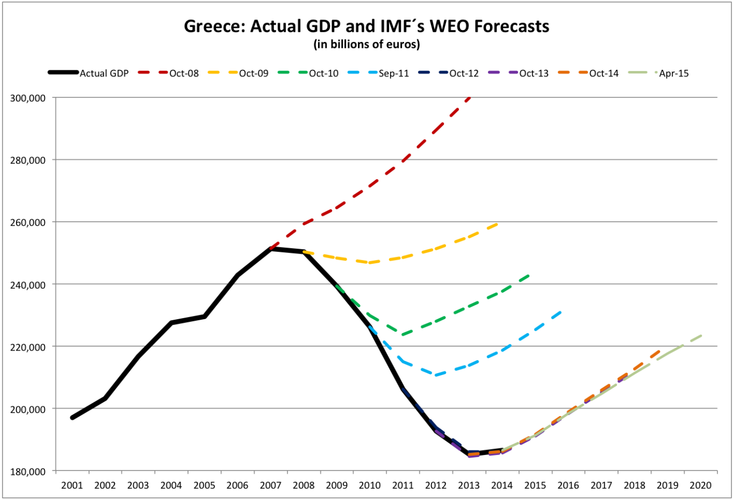
- **The situation in a nutshell - Stage I**:
  - New economic regime from December 2015 brings change in access to credit markets and positive shock to market expectations
  - Substantial fiscal deficits + tight inflation targeting (such that seignoreage $\ll$ fiscal deficit) $\Longrightarrow$ **rapid increase in public debt**
    - Initially seen as sustainable under optimistic expectations

- **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 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


Argentina: Real GDP and IMF projections
Index 2017=100
108
106
104
102
100
98
96
94
92
2014
2015
2016
2017
2018
2019
2020
2021
Jul-18 Stand-by
Oct-18 1st Rev.
Dec-18 2nd Rev.
Apr-19 3rd Rev.
Jul-19 4th Rev.
Oct-19 Weo
Real GDP

Reminds us of Greece (from Guzman-Heymann 2015, JGD)



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

- 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

$\Longrightarrow$

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

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

    $\Longrightarrow$

    - 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?