
Discussion

The Design of a Mechanism for Resolving
Sovereign Debt Crises and its Interaction
with an ILLR

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Disclaimer

- I will based my discussion on “International Lending of Last Resort (ILLR) and Sovereign Debt Restructuring” by Eduardo Fernández -Arias

The “Next Keynes” game

- There are already 30 years of ILLR and SDRM behind us (see Rogoff and Zettelmeyer (2002) for a review)
- Almost every big name in international finance has presented its proposal
- Two separate issues:
 - ✓ LLR could break multiplicity of equilibria (risk of runs on illiquid but solvent)
 - ✓ Sovereign Debt Restructuring (SDR) institutions could improve coordination during debt restructuring and generate gains in efficiency
- This paper puts both issues together under the same institutional framework

EFA's proposal in a nutshell

The Proposal: ILLR with debt restructuring under its umbrella

- A multilateral ILLR = IMF plus multilateral development banks
- An integrated system of specialized ILLR facilities to deal with situations requiring:
 - ✓ Liquidity facility
 - ✓ Fiscal adjustment facility
 - ✓ Debt restructuring facility
- The ILLR should also have legal powers to grant a standstill on international payments and seniority to fresh interim lending
 - ✓ Granting standstill triggers facilities

Comments

1. Well-thought proposal
 - Makes clever use of existing financial architecture
 - Automatic inclusion in IMF's Flexible Credit Line (FCL)
 - Coordination between IMF and multilateral development banks to lend during crises
2. Contract design or institutions?
3. Sovereign Debt Restructuring and the costs of sovereign defaults
4. Further thoughts

Contract design or institutions?

- The possibility of default makes sovereign bonds implicitly contingent contracts
- The problem is that defaults are an expensive way of adding contingency to the contract
- Better way: move towards more explicitly contingent contracts
- Welfare gains of moving to GDP – indexed debt could be significant (see Sandleris et al (2009))
- Why did most real-indexation initiatives fail so far?
 - ✓ Externalities in opening new markets? If so, there might be a role for the IFI's

Sovereign debt restructuring and the costs of defaults

- Agreement on the need for some form of ILLR
 - ✓ Multiple equilibria argument
 - ✓ But the IMF has insufficient funding to deal with debt crisis in Europe (US\$ 395 bn)
- Regarding the need for a Sovereign Debt Restructuring institution, I believe that we might have been:



The case for SDR institutions

Sachs (1995)

“Both Macy's Department Store and the Russian Government suspended debt servicing in January 1992. Macy's filed for Chapter 11 protection, while the Russian Government notified the G-7 creditors that it would be unable to continue to service the debt. Macy's received an immediate and automatic debt standstill at the time of filing. Just three weeks later, Macy's was able to arrange a fresh loan of \$600 million from several N.Y. commercial banks, as debtor-in-possession (DIP) financing.”



The rationale behind SDR arrangements

- The idea is to coordinate creditors and give a debtor some breathing room in the event of a default by:
 1. Preventing a grab race among creditors that would force the debtor country to liquidate potentially high-yield investments
 2. Avoiding free-riding among creditors
 3. Speeding up the restructuring process
 4. Granting seniority to interim lenders

How relevant are these concerns?

- Has (1) been really relevant?
- Can't CAC deal with holdouts?
- It did not take that long to reaccess the market (Gelos et al. (2011))

Decade	Episodes	Mean
1980s	29	4.5
1990s	10	2.9
All	39	4.1

- Granting seniority could help but we do not need an international sovereign bankruptcy court for that
 - ✓ IFIs already have the seniority
 - ✓ Once a default occurs, the ILLR can grant seniority to lenders providing new money
 - ✓ Also, fiscal situation critical in determining need of fresh funds

What makes sovereign defaults costly?

- Sovereign defaults are costly not because there is poor coordination among creditors during the restructuring
- The main costs of sovereign defaults are related to:
 - Information revelation (Cole and Kehoe (1998), Sandleris (2008)) and non-discrimination (Broner and Ventura (2011))
- The costs of defaults become really large when they disrupt the domestic financial system (see Sandleris (2010) and Gennaioli et al (2010))
 - In the year following a sovereign default, private credit falls by 2.4 points as a fraction of GDP and by 8.6% in absolute terms
 - Post-default credit crunch is stronger in countries that are financially more developed and where banks hold more public debt

The big issues

- May be it is time to focus on what makes defaults really costly:
 - ✓ Why do banks hold so much sovereign debt?
 - ✓ Can this be changed?
 - ✓ How do we prevent governments from “betting for resurrection”, gambling the domestic financial system in doing so?

Further thoughts on the proposal

Sovereign Bankruptcy Court with another name?

- How would the ILLR decide whether a default is excusable?
- Would there be a trial? If so, isn't this just an "international sovereign bankruptcy court" with another name?

What should the ILLR maximize?

- The proposal states that:

“The interest of the ILLR is to promote a reorganization that combines country adjustment (including policy reform) and debt restructuring in a way that serves the best interests of the country”

- Is it so simple? When we think about Greece, shouldn't we be thinking about the effects on Italy or Portugal or Germany? How would stock holders in ILLR affect its decisions?

Further thoughts on the proposal

- We do have an International Center for Settlement of Investment Disputes (ICSID) under the WB umbrella that acts as an “international court” for investments
 - ✓ Has it worked? Argentina takes part in the trials but, so far, has not paid