Debt Resolution Mechanisms: Should there be a Statutory Mechanism for Resolving Debt Crises?

by

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Sovereign Debt Resolution Mechanisms: An ECB Perspective

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Overview

I. Private sector involvement (PSI) in the context of sovereign financial distress

II. Debt restructuring – a changing picture but no free lunch

III. Statutory vs. contractual debt restructuring mechanisms

IV. EMU and PSI

V. The ECB position on private sector involvement
PSI in the context of sovereign financial distress

- PSI can take various forms with different degrees of voluntariness/formalisation
  - Commonalities: intentional collaborative efforts, undertaken by private sector creditors, in a context of sovereign financial distress

- **Rationale for PSI**
  - Addressing (creditor) moral hazard problem (the private sector should not rely on taxpayers’ bailout)
  - Fostering adequate pricing of sovereign risk
  - Triggering a fair burden sharing between policy adjustment and financing on the one hand, between public and private money on the other hand
Debt restructuring – changes through time

• Long history of sovereign debt problems/crises, including in advanced economies before WW II

• **Before 1990s:** Sovereign debt workouts concentrated on official lending (Paris Club) and syndicated bank loans (London Club)

• **Since the 1990s:** Private capital is the main source of sovereign financing
  • Increasing share of bond/equity financing and interbank credit
  • Increasing share of short-term financing
  • Increasing fragmentation of creditor
  • Increasing share of domestic currency issuance
Debt restructuring – at a cost

Debt restructurings are no free lunches for sovereigns

• Penalty and reputational costs
  ▪ Higher future borrowing costs for the sovereign
Debt restructuring – at a cost

Higher haircut countries face higher spreads for many years

The sample is split at H=37%, the median haircut among defaulters.

Debt restructurings are no free lunches for sovereigns

- Reputational/penalty costs
  - Higher future borrowing costs for the sovereign
  - Loss of market access
Debt restructuring – at a cost

Years of exclusion from international capital markets after debt restructuring

Debt restructuring – broader economic costs

Debt restructurings are no free lunches for sovereigns:

• Broader costs to the domestic economy
  – Output losses
  – Effects on private sector borrowing
  – Negative feedback loop through the financial sector
  – Impact on domestic creditors

• Contagion effects on other economies
Debt restructuring – the cost of complexity

Dimensions to be dealt with in a debt restructuring process

- Solvency vs. Liquidity
- Seniority / Debt Dilution
- Holdout Problem
- Fairness and Transparency
- Speed and Efficiency
- Moral Hazard
Reducing the complexity of debt restructuring

**Institutional**: Paris Club, London Club

**Statutory**: Sovereign debt restructuring mechanism

**Contractual**: Collective Action Clauses (CACs)

**Voluntary**: Code of good conduct

- Jointly agreed between sovereign debtors and their private creditors and investors
- Transparent and timely flow of information
- Close debtor-creditor dialogue and cooperation to avoid restructuring
- Voluntary and good faith-based restructuring process if restructuring becomes inevitable
- Fair treatment of affected creditors
The IMF perspective on PSI

- **Case-by-case approach**

- **Preference for market-oriented (non-distressed) solutions and voluntary (non-binding) approaches (thereby minimising the occurrence of costly rating and credit events)**

- **Escalating approach based on the debtor country situation, notably its payments capacity, prospects for market access and debt sustainability**

- **Decisions rest with the debtor country**
Previously, default and debt restructuring only concerned small to medium-sized EMDCs – with public debt levels mostly below 100% to GDP.

Default was typically triggered by a FX crisis, which increased the burden of external debt in an unsustainable way:

- Debt restructuring mainly affected foreign creditors, and particularly not domestic banking sector.

Operations were limited to single countries with limited spillover for others (except for the Latin American crisis and the Brady initiative).
EMU and PSI – Communication and spillovers

Source: Haver Analytics and ECB Staff Calculations.
Note: In case of 2-day council meetings, the last day of the meeting is marked in the chart.
Latest observation: 07 November 2011
EMU and PSI -
Market reactions to communication and spillovers

S&P ratings (x-axis) and 5-year CDS (y-axis, basis points) for selected countries within and outside the euro

1 June 2009

9 September 2011
**EMU and PSI – Communication by the ECB**

**Treaty/statutory obligations:**

- **ECB cannot lend to sovereigns or buy their debt in primary markets**
- **Collateral accepted by the ECB has to be of adequate quality**
- **The ECB has a primary objective to maintain price stability**
- **The ECB is expected to contribute to preserving financial stability in the euro area as a whole**
The euro area and PSI – The unique case of Greece

- Fully in line with IMF practice (case-by-case approach; pre-emptive) – see also the draft ESM Treaty
- Greece as a unique case in the euro area; all others are inflexibly determined to fully honour their own sovereign signature
- Avoid a credit event (hence a voluntary approach)
- Selective/restricted default unavoidable → need to credit enhancement of Greek sovereign (or government guaranteed) collateral with the Eurosystem