



# **Eighth UNCTAD Debt Management Conference**

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

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

# **Sovereign Debt Resolution Mechanisms: An ECB Perspective**

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**Geneva, 14 November 2011**

# 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

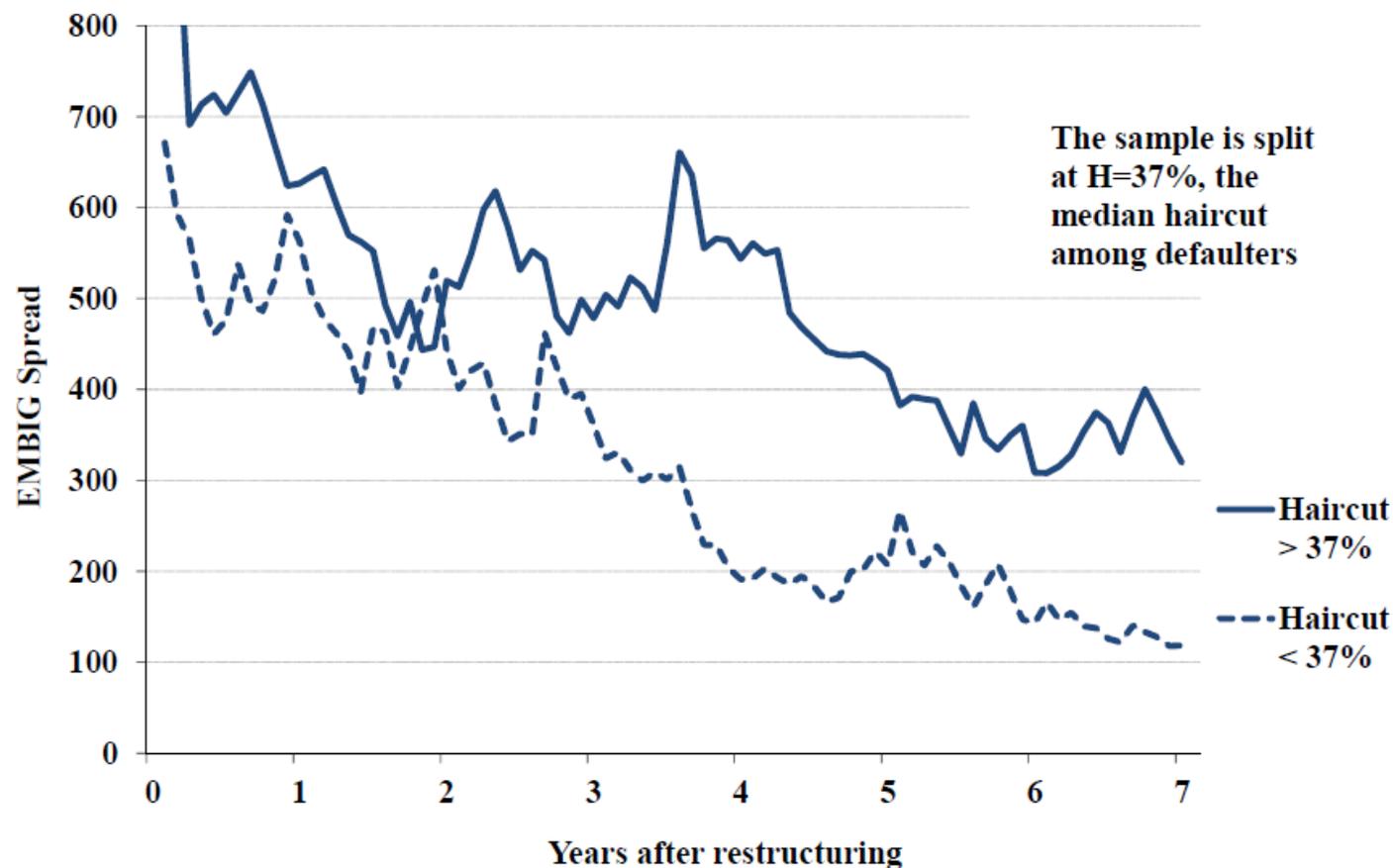
# Debt restructuring – at a cost

**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



Source: Cruces and Trebesch (2011). 'Sovereign Defaults: The Price of Haircuts', mimeo.

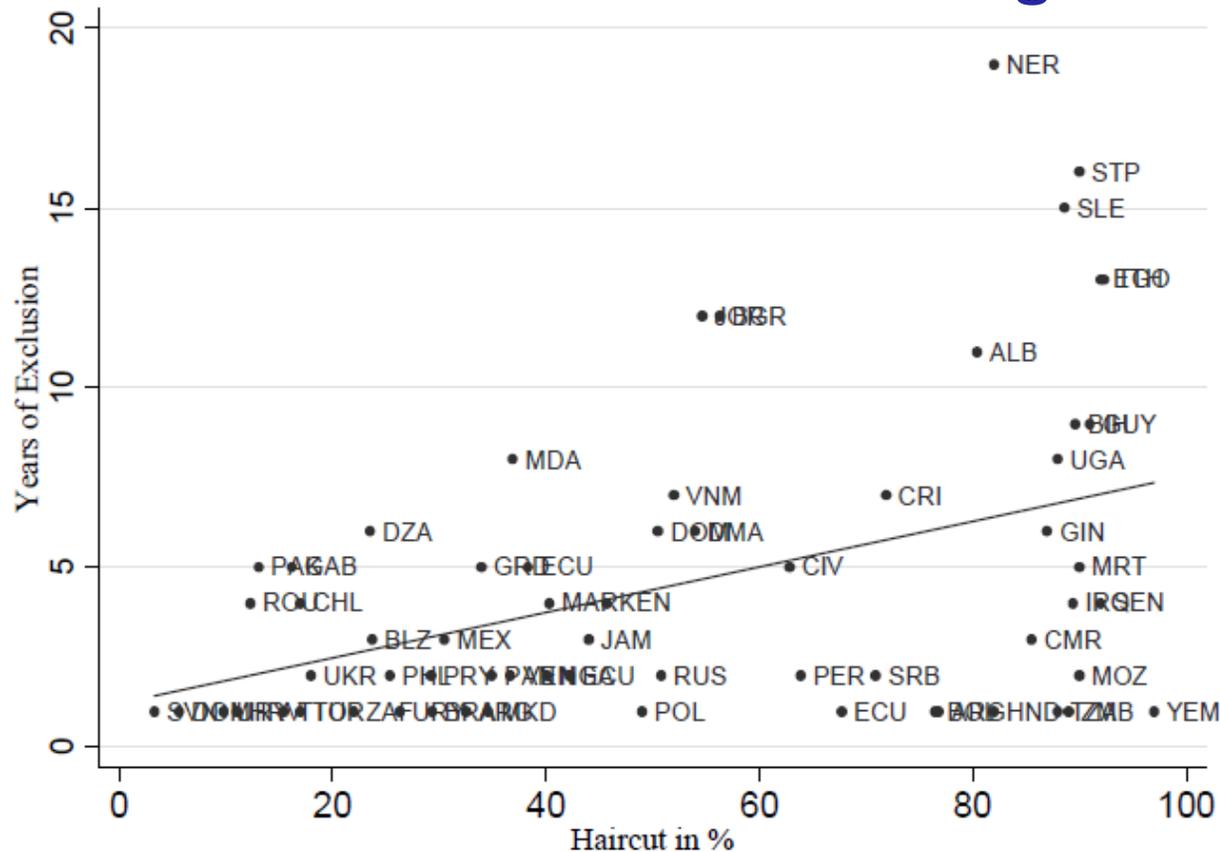
# Debt restructuring – at a cost

## 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



Source: Cruces and Trebesch (2011). 'Sovereign Defaults: The Price of Haircuts', mimeo.

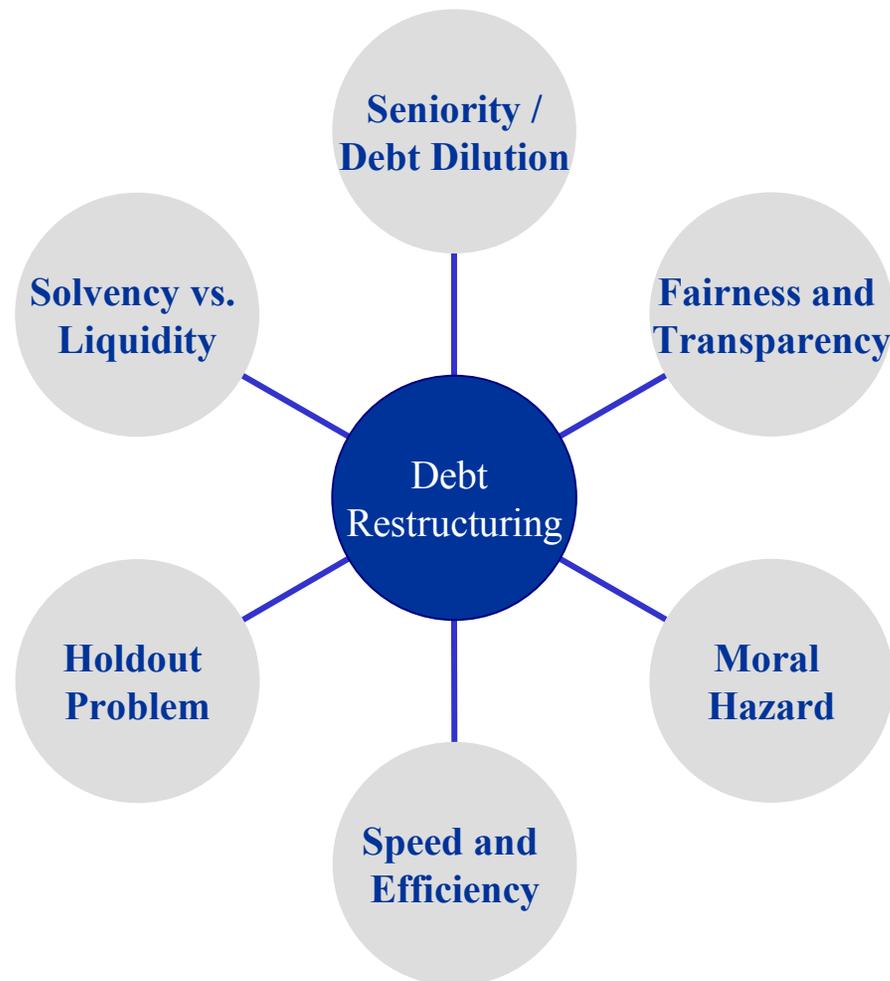
# Debt restructuring – broader economic costs

## Debt restructurings are no free lunches for sovereigns:

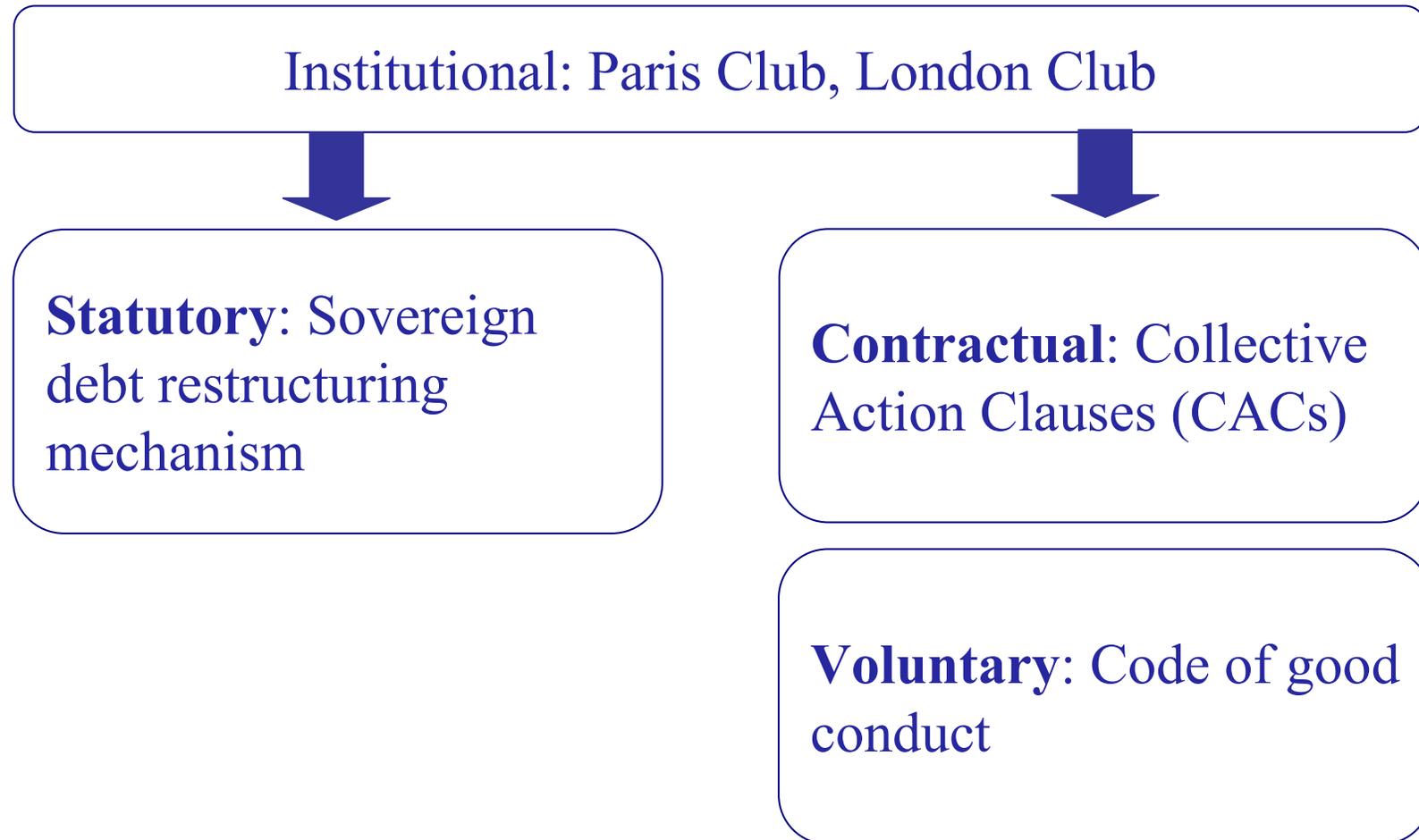
- **Broader costs to the domestic economy**
  - **Output losses**
  - **Effects on private sector borrowing**
  - **Negative feedback loop through the financial sector**
  - **Impact on domestic creditors**
- **Contagion effects on other economies**

# Debt restructuring – the cost of complexity

## Dimensions to be dealt with in a debt restructuring process



# Reducing the complexity of debt restructuring



# The voluntary approach to PSI

## Principles for Stable Capital Flows and Fair Debt Restructuring (2004)

- **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**

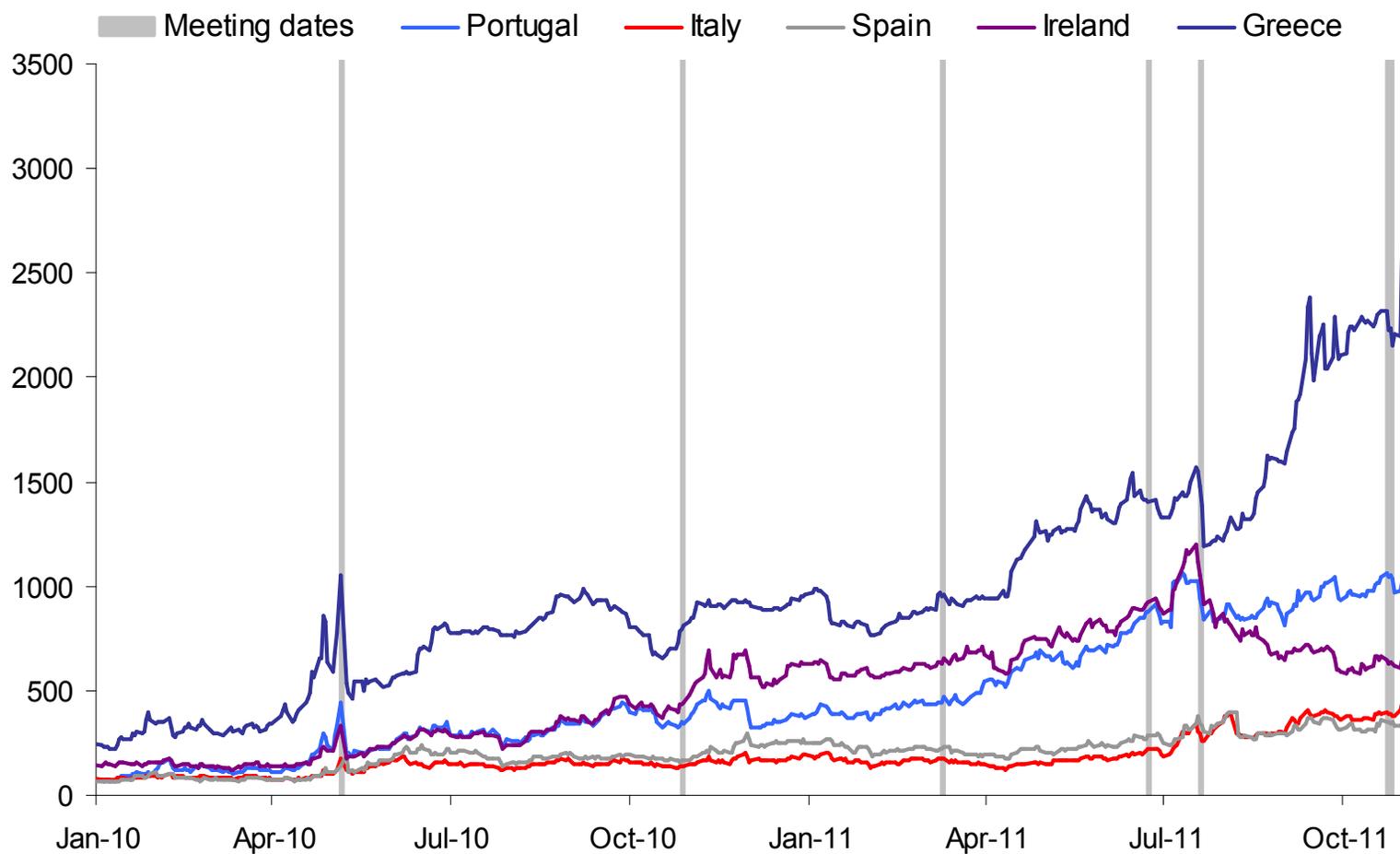
# The IMF perspective on PSI

- **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**

## EMU and PSI - little guidance from the past

- **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.

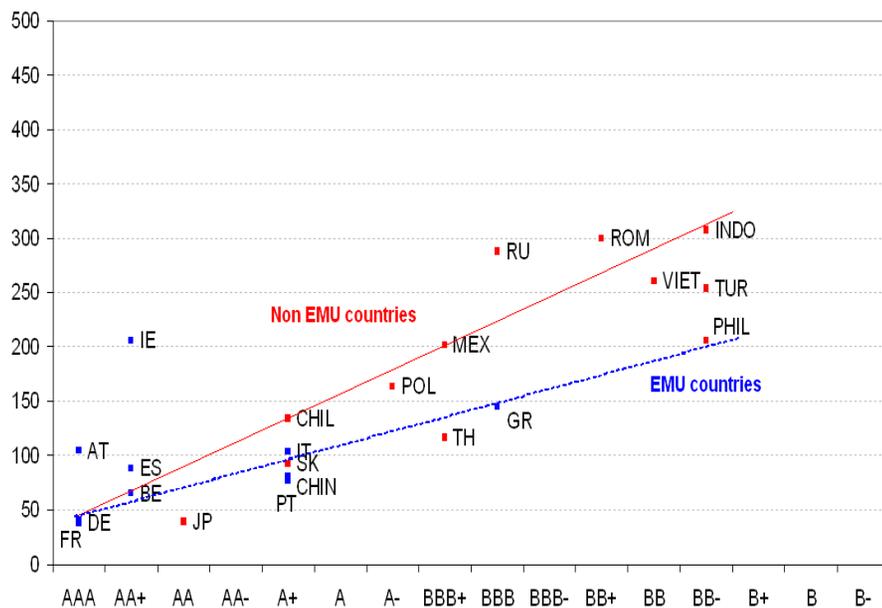
Note: In case of 2-day council meetings, the last day of the meeting is marked in the chart.

Latest observation: 07 November 2011

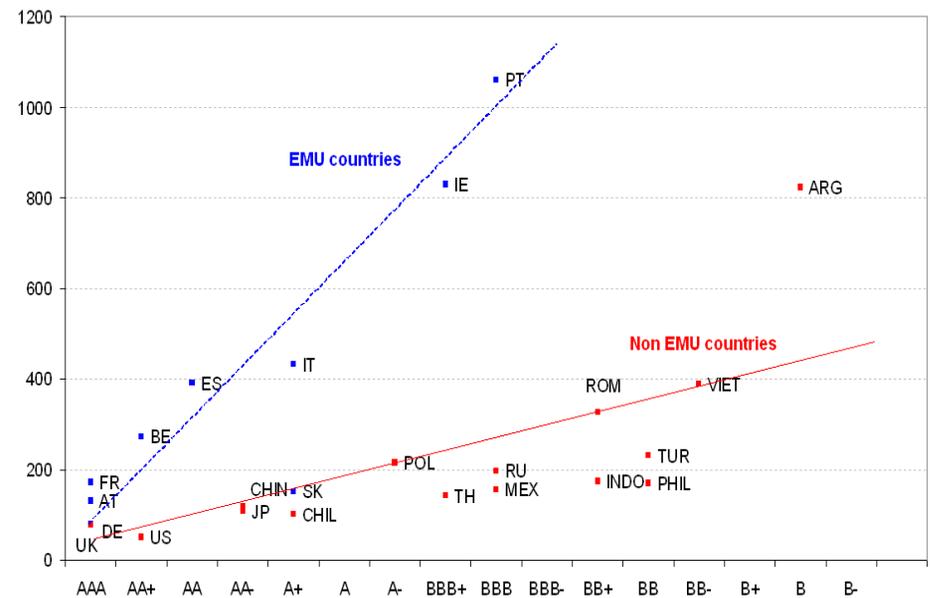
# EMU and PSI - Market reactions to communication and spillovers

**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**