



Eighth UNCTAD Debt Management Conference

Geneva, 14 - 16 November 2011

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

by

Mr. Frank Moss

Director General, International Relations

European Central Bank

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

Sovereign Debt Resolution Mechanisms: An ECB Perspective

Frank Moss

**Director General International and European Relations
European Central Bank**

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

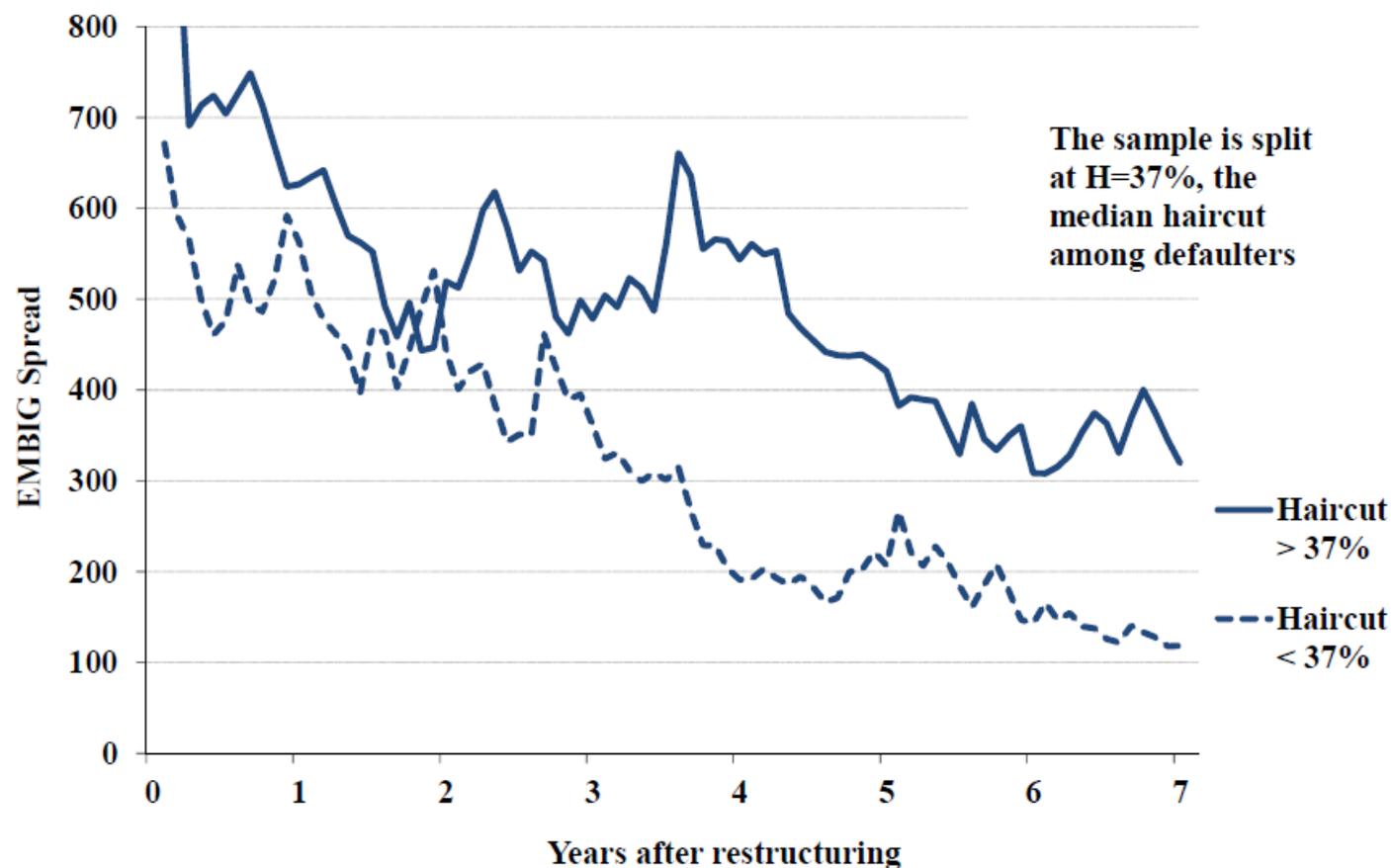
Debt restructuring – at a cost

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.

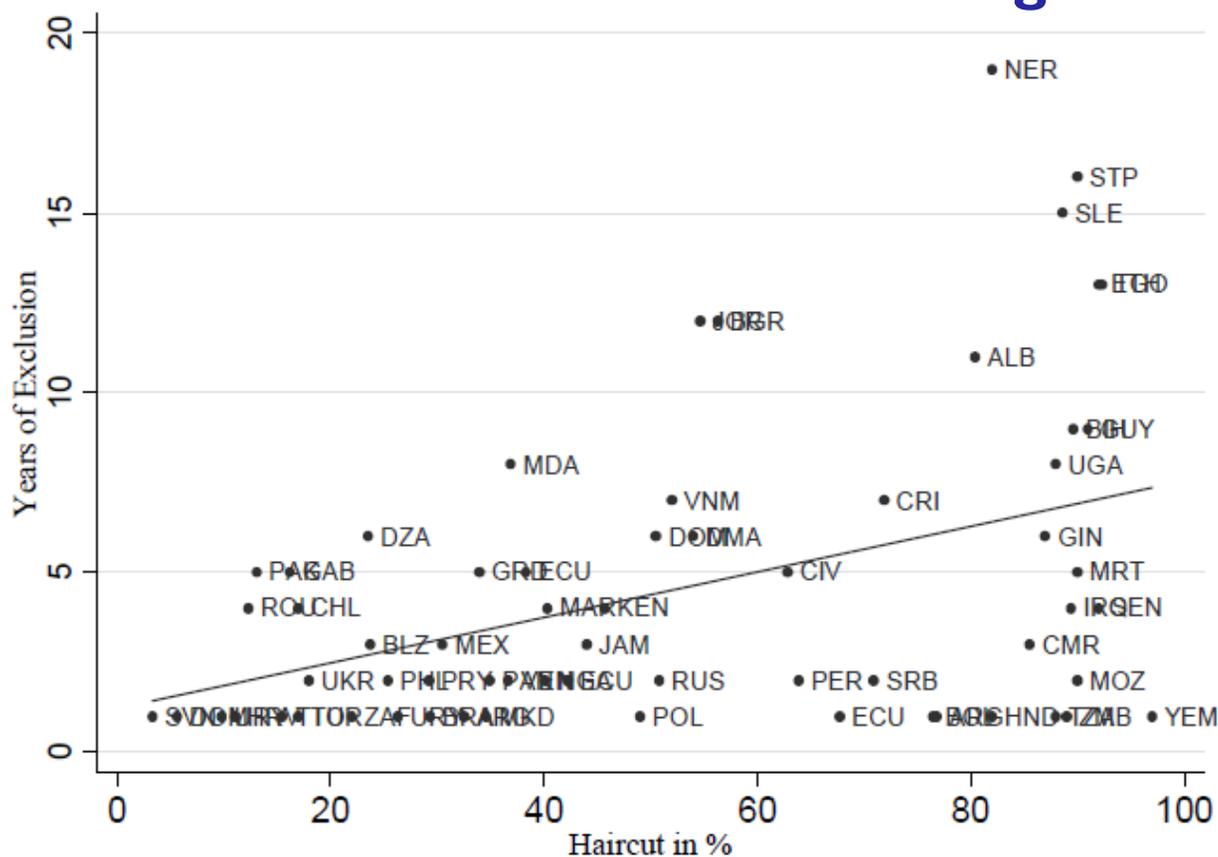
Debt restructuring – at a cost

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.

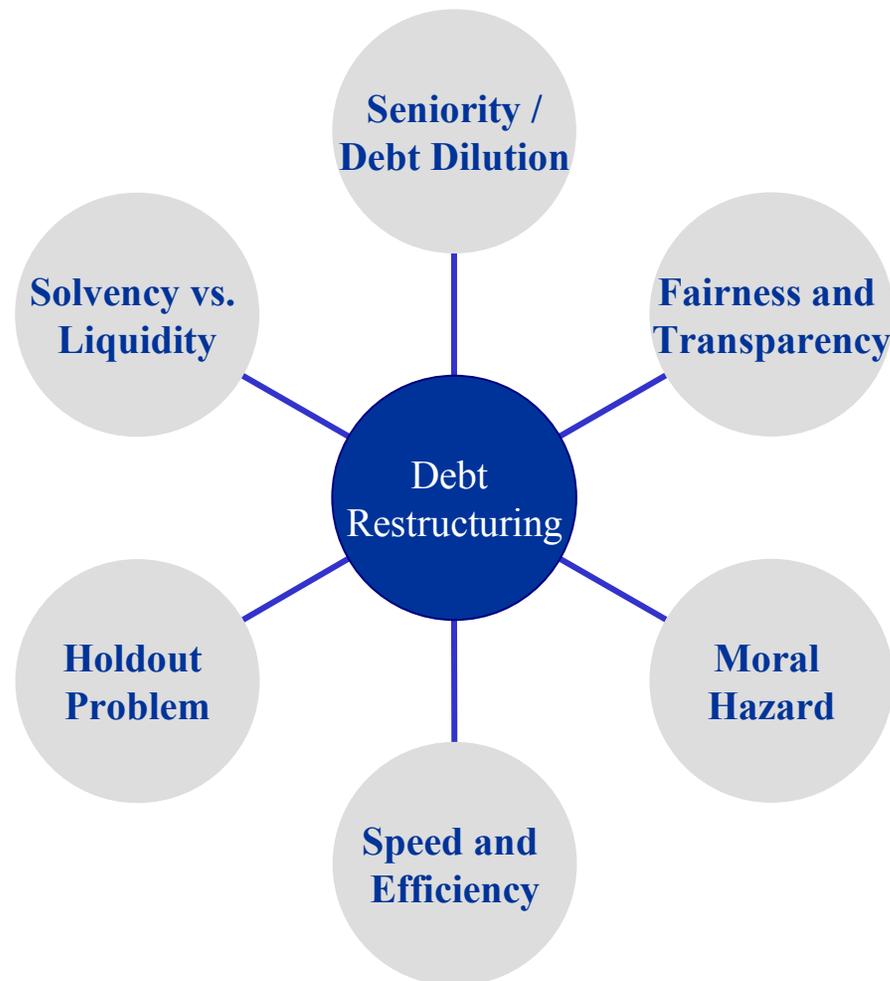
Debt restructuring – broader economic costs

Debt restructurings are no free lunches for sovereigns:

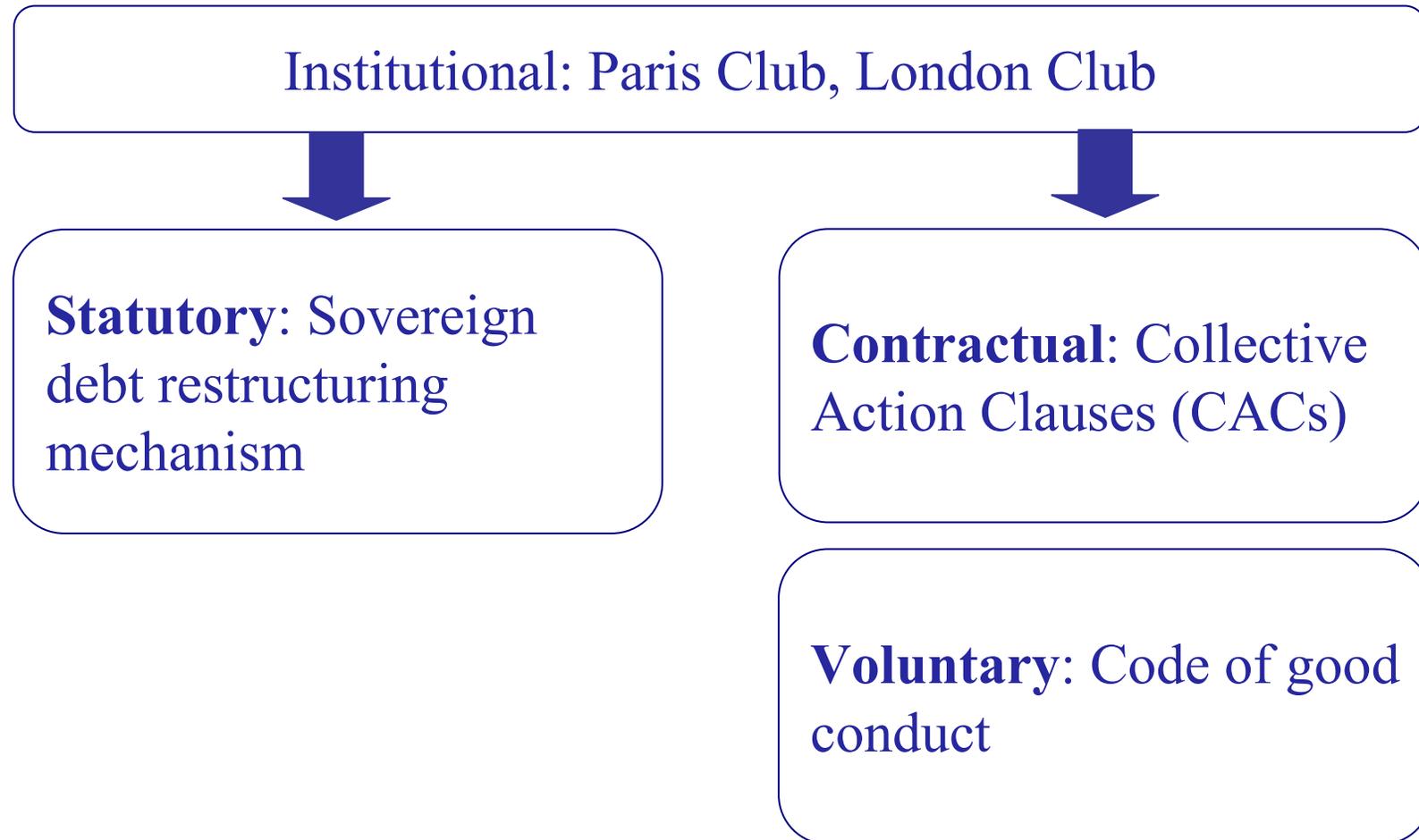
- **Broader costs to the domestic economy**
 - **Output losses**
 - **Effects on private sector borrowing**
 - **Negative feedback loop through the financial sector**
 - **Impact on domestic creditors**
- **Contagion effects on other economies**

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**

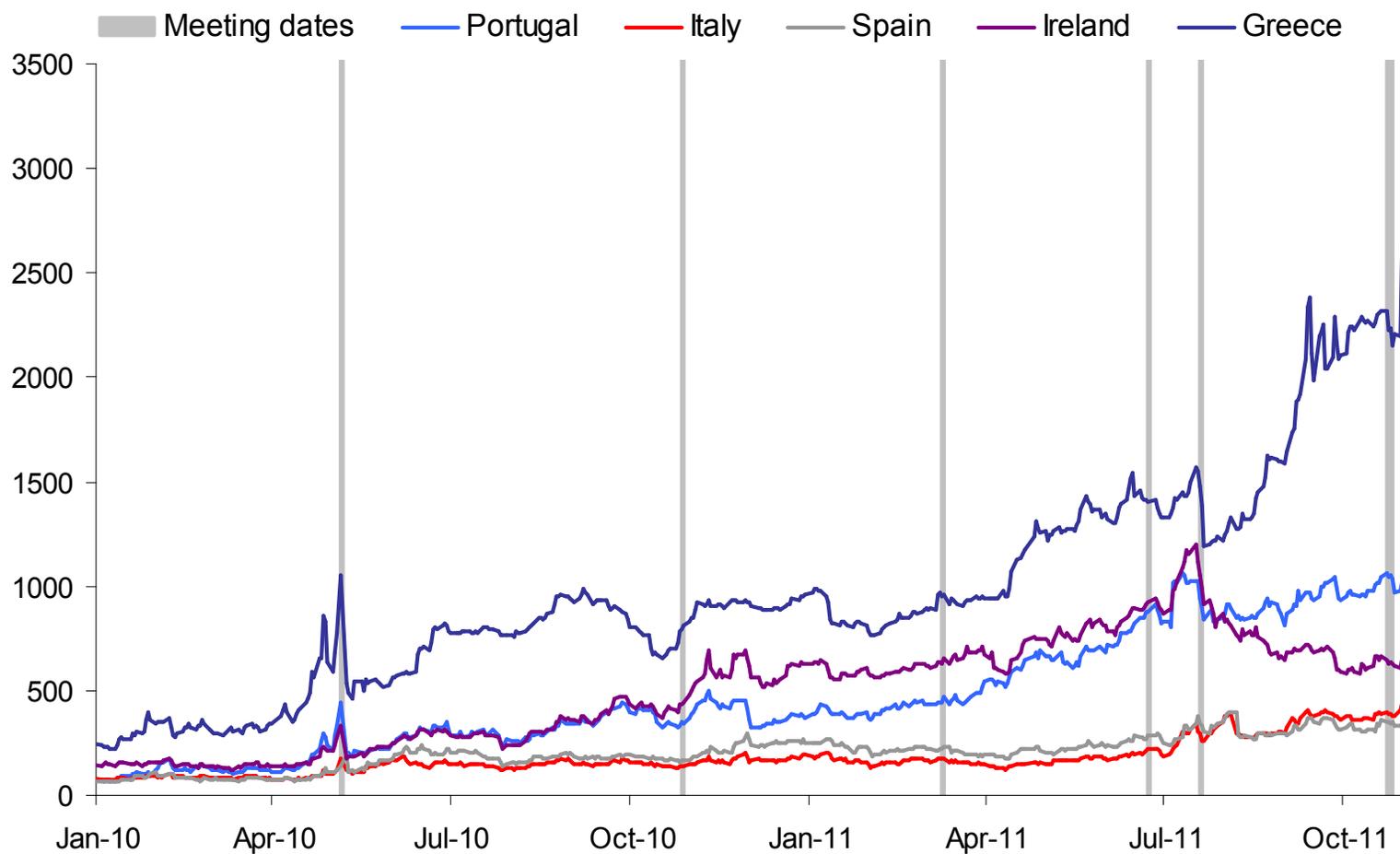
The IMF perspective on PSI

- **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.

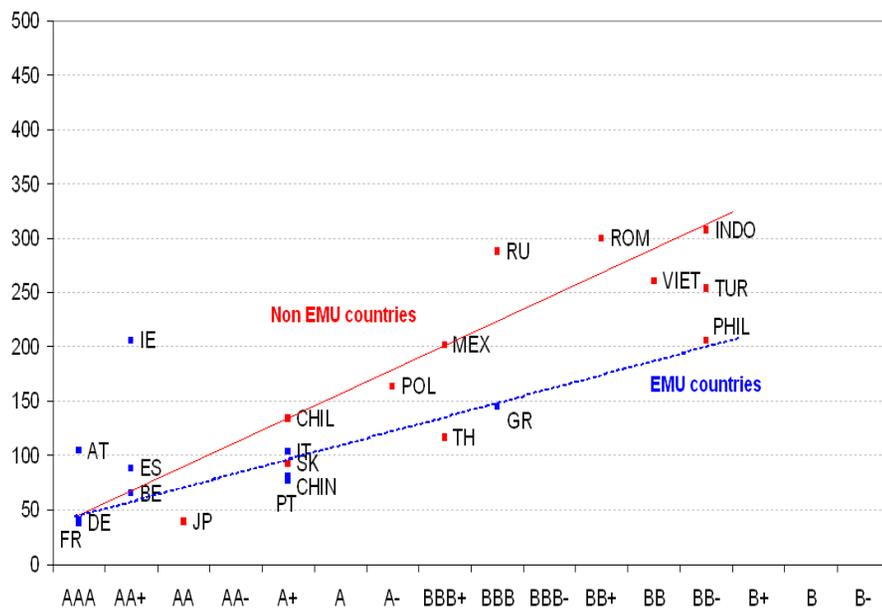
Note: In case of 2-day council meetings, the last day of the meeting is marked in the chart.

Latest observation: 07 November 2011

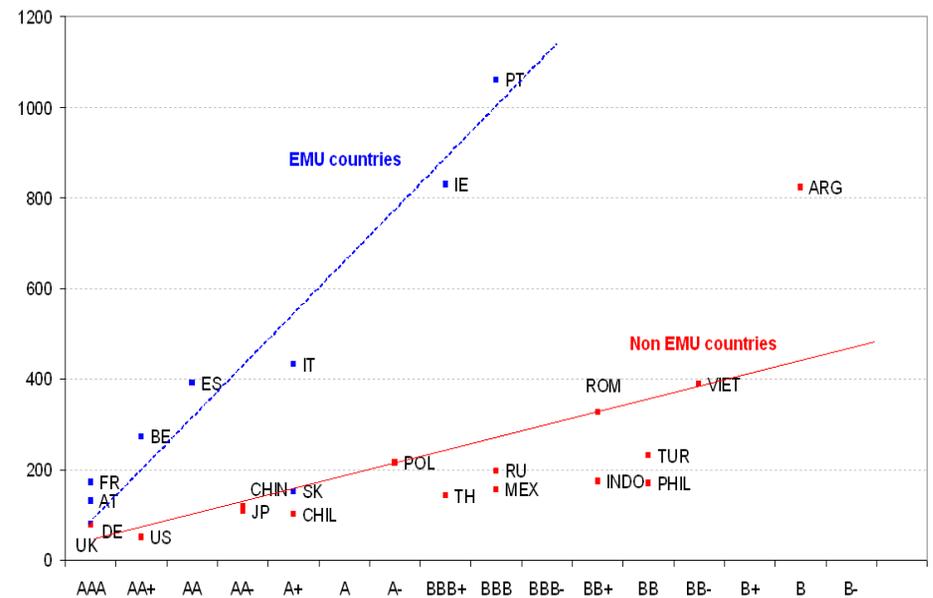
EMU and PSI - Market reactions to communication and spillovers

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**