Managing Sovereign Debt Sustainability Risks

Intergovernmental Group of Experts on Financing for Development

United Nations, Geneva

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Multiple sources of risk

- Undoing Quantitative Easing → Quantitative Tightening
Multiple sources of risk

- Time of changes: political, technological
- Bouts of volatility while learning takes place
Incomplete contracts

Written as non-contingent but contingent in practice

- Debt payment capacity is stochastic

No multinational legal system for resolving sovereign debt distress
What happens when sovereign debt distress arises?

The standard anatomy:

- Change in market expectations
- Increase in the cost of debt rollover
- Fiscal austerity and new loans (possible from official creditors) to meet larger debt payments
- Lower economic growth, lower fiscal revenues, more debt distress
What happens when sovereign debt distress arises?

- **A note on the evidence:**
  - 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.
What happens when sovereign debt distress arises?

- Eventually, there is a debt restructuring
  - “Too late”, and often delivers “too little” relief
<table>
<thead>
<tr>
<th>$t$</th>
<th>Fraction</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>0.497</td>
</tr>
<tr>
<td>4</td>
<td>0.525</td>
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<tr>
<td>5</td>
<td>0.553</td>
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<tr>
<td>6</td>
<td>0.575</td>
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<tr>
<td>7</td>
<td>0.6</td>
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</tbody>
</table>

1970-2013: fraction of sovereign debt restructurings with private creditors followed by another restructuring or default with private creditors within $t$ years.
What happens when sovereign debt distress arises?

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

<table>
<thead>
<tr>
<th>$t$</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Income</td>
<td>0.619</td>
<td>0.650</td>
<td>0.700</td>
<td>0.700</td>
<td>0.700</td>
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<tr>
<td>Upper Middle Income</td>
<td>0.500</td>
<td>0.548</td>
<td>0.578</td>
<td>0.590</td>
<td>0.622</td>
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<tr>
<td>Lower Middle Income</td>
<td>0.467</td>
<td>0.477</td>
<td>0.500</td>
<td>0.523</td>
<td>0.548</td>
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<tr>
<td>Low Income</td>
<td>0.455</td>
<td>0.455</td>
<td>0.469</td>
<td>0.531</td>
<td>0.548</td>
</tr>
<tr>
<td>Total</td>
<td>0.497</td>
<td>0.525</td>
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What happens when sovereign debt distress arises?

- Finalization of a restructuring process can take too long due to holdout/vulture funds behavior
Increasing litigation (Schumacher-Trebesch-Enderlein 2018 ECB WP)

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The roots of the problems

- Deficient international financial architecture
- Domestic legislation
  - Punitive “compensatory interest rate” for missed payments (9% under NY law)
  - Legislation that favors vulture funds’ business
What can be done to improve matters?

- Domestic policies
  - International capital flows management
  - Choice of jurisdictions for debt issuance
- Larger-scale adoption of contingent debt (GDP growth bonds)
  - Important work from the Bank of England, Bank of Canada, Peterson Institute for International Economics
- Need for a multinational system for sovereign debt restructuring based on sound principles
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
A Soft Law Approach for Sovereign Debt Restructuring Based on the UN Principles (Guzman-Stiglitz 2016)

Principles-based sovereign debt sustainability

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

- Deficient outcomes in the practice for sovereign debt restructuring
- Mounting risks
- Substantial room for improvement
  - Reforms to the international financial architecture
  - Better contracts
  - Management of international capital flows
  - Different approaches for assessing sovereign debt sustainability (principles-based)

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