International Lender of Last Resort and Debt Restructuring

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(personal views)

Preventing and Managing Debt Crises to Promote Sustainability
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Outline

1. The Financial Safety Net System

2. Debt Restructuring Facility

3. Preventing Debt Crises

1. The Financial Safety Net System
Where we are and where we need to be

- Increasing need for International Lending of Last Resort (ILLR) to deal with country financial crises (market not willing or able to lend) as financial globalization deepens and spreads
- The international financial safety net to protect against liquidity and solvency crises has holes
- However, after a very slow progress, there are at last some successful new facilities to build on and new multilateral momentum to ride on!

Confusions of ILLR

- We know what to do in a liquidity crisis (pour liquidity) but we don't know how to distinguish it from a solvency crisis and are afraid of moral hazard
- We are not sure how to structure adjustment lending for countries to regain solvency and are afraid countries will not agree and follow through
- We don't know what to do if debt restructuring is needed (no multilateral framework for resolution)
- And situations evolve, morphing liquidity crises into solvency crises needing adjustment…or restructuring

The financial safety net we need

- We need a system of ILLR ready to address liquidity and solvency crises in a robust and coherent fashion across a wide array of countries
- The following ideas exemplify such system. More details in *International Lending of Last Resort and Sovereign Debt Restructuring* (WB book *Sovereign Debt and the Financial Crisis: Will This Time Be Different?*)
- Here I emphasize Debt Restructuring Facility and expand to Prevention

A modest proposal: Supporting and building on IMF New Facilities

- Principle: Adapt domestic institutions (liquidity back up, bankruptcy process)
- Objective: Best and widest protection tailored to financial need and country capacity
- Specialized facilities structured to address specific shocks with up-front support
- Prior country eligibility in a tiered structure catering to countries' capacities
- Looks complex, but one-size-fits-all facilities are bound to be too selective or too weak

The design of a feasible ILLR is very constrained

- For effectiveness needs to achieve a lot:
  - **Power**: critical mass to restore/keep confidence
  - **Speed**: automatic delivery (avoid Humpty Dumpty fall)
  - **Certainty**: No fine print or last-minute activation clause
- But it lacks traditional instruments of LLR:
  - No marketable collateral: Financial safeguards
  - No enforceable regulation to limit risk taking: Prudential conditions for eligibility
  - No bankruptcy court to enforce workout: Carrots and sticks to enforce conditions on stakeholders

Basic design principles of a feasible ILLR facility

- **Prior country selection** based on **preset eligibility conditions** of financial safety and economic health with facility-specific, simple objective standards on:
  – Soundness of Fundamentals
  – Quality and stability of Policy Framework
- **Country prequalification** with no commitment fee to avoid stigma and adverse selection
- **Ex-post conditionality** on adjustment/reform and debt restructuring **only as needed** to restore solvency
- **Tiers:** Calibrate eligibility standards and extent of conditionality to countries' capacities

Example A: Systemic Liquidity Facility

As in Global Financial Safety Nets (EFA & ELY, forthcoming in International Finance)

- **Triggered by widespread liquidity crunch** as in widespread financial contagion in EMBI
- **Automatic up-front access to liquidity from global issuers** (instead of international reserves)
- **Wide Basic Tier** (e.g. good standing in Article IV); **Top Tier** (e.g. solid macro) gets more access because has lower risk of solvency concerns

Example B: Country Liquidity Facility

- **Available on demand** (at steep rate) to offset a country-specific liquidity crunch
- **Automatic up-front access to a degree of liquidity insurance** dependent on:
  - **Country Tier** (fundamentals)
  - **Marketable Assets** (sovereign wealth fund)
  - **Type of Shock** (e.g. exogenous shocks presume lower risk of solvency concerns)
- **Monitoring** to seamlessly switch to Adjustment Facility if temporary liquidity does not do it (err on the side of caution)

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Example C: A family of FCLs to deal with Liquidity cum Adjustment

- **Calibrate automatic up-front access and ex-post conditionality program** according to tiers:
- **Senior FCL** (e.g. excellent macro, such as in FCL): full access, no conditionality
- **Junior FCL or PCL** (including disqualified Senior FCL) get some automatic access and then transition to adjustment with ex-post conditionality
- **Monitoring** to transition to Debt Restructuring Facility if needed

The Phantom of Moral Hazard

- Undue moral hazard concerns blocks the FSN
- Useful lending with financial safeguards (prima facie solvent cases) does not distort incentives (as opposed to insurance)
- Leads to more risk taking…efficiently, not constrained by lack of FSN
- May exacerbate private moral hazard if regulation faulty, but as much as domestic financial safety net: opportunistic argument?

2. Debt Restructuring Facility

- There is no multilateral system for sovereign debt restructuring
- Current non-system based on breach of contract or threat of breach and chaos; lawyers' paradise
- DRF needs to redefine solvency and bankruptcy for the case of sovereigns based on economic rationality to achieve debt sustainability…
- …and incorporate debt restructuring under the umbrella of FSN and ILLR

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Debt Restructuring Facility associated with the ILLR function

- **If and when debt restructuring is needed to regain solvency** (there is debt overhang)
- **Multilateral debt workout plan includes:**
  - Certification (or not) of “excusable” default
  - Arrangements for automatic ILLR interim financing
  - Adjustment and reform conditionality
  - Guidelines for appropriate private sector involvement in debt restructuring
- But carrots and sticks may be insufficient

Lack of coordination is not the main problem: announcing a plan is not enough

- Bond debt has been renegotiated despite coordination difficulties, with or without CACs
- But perfectly coordinated private lenders will find it optimal to minimize haircuts betting for good luck (or else costly repeated restructuring)…
- … and governments will find it optimal to delay restructuring betting for good luck

KEY REFORM: Sovereign Debt Restructuring with Bankruptcy Court (instead of carrots and sticks)

- **ILLR can enforce** adjustment/debt restructuring plan with lenders (contractually-based or by accord)
- **Standstill on payments and stay on litigation**
  - Avoids system based on contract breaching and litigation, costly to countries' reputations
  - Gives ILLR time to device "optimal" reorganization plan and teeth to enforce it with standstill in hand.
- **Senior priority to interim financing**, allowing for private sector involvement (akin to country insurance thru dilution); less ILLR resources needed.

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Would it make restructuring “too easy” for Dooley?

- DRF reduces illiquidity and uncertainty at the root of domestic cost of default; would that lead to smaller sustainable debt and be counterproductive?
- Confusion 1: With uncertainty, smaller default cost (and debt) may be good (too much of a good thing…)
- Confusion 2: With certification of standard for excusable default, DRF can offer insurance (always good) and government need not delay to prove it
- DRF can optimally shape costs of default, increasing cost of opportunism

How is DRF triggered? Who calls the DRF?

- Country Call. DRF as bankruptcy protection. The problem is that political economy leads to delay
- Multilateral Call. Technocratically better and natural extension of failed adjustment programs, but sovereigns may see it as a damaging overreach
- Automatic Call when preset and agreed sustainability criteria cease to be complied with. Criteria may have originated in country, with multilateral enforcing.

3. Preventing Debt Crises

- So far focus on ex-post safety net. Nevertheless, proposed architecture provides good incentives ex-ante (with moral hazard under control):
- Prior country selection to ILLR benefits incentivize countries' effort to reach eligibility standards
- Precautionary incentives magnified by:
  - No commitment fee to maximize benefit and use
  - Proactive country prequalification (all in play)
  - Tiered structure provides marginal incentive to elicit countries' effort at all levels; unattainable conditionality is useless

The Role of Prudential Conditionality embedded in eligibility criteria

- The FSN ought to impose conditionality concerning international prosperity beyond national prosperity

- Conditionality to enhance credibility and enforcement of national policies (e.g. concerning domestic financial regulation)

- Conditionality to offset domestic governance distortions? E.g. concerning international insurance seen as too expensive because of discounting

Monitoring is key for the system

- The cost of suboptimal policies accrue to the country if there is clarity about them and transparency on outcomes; otherwise market diffuses it to others
- Therefore monitoring and information are legitimate interests of conditionality…
- …and may actually be an additional tool for countries: let the sovereign express its intentions to comply with certain policy framework/eligibility criteria and monitor compliance (affords signal value)

Principles for Responsible Borrowing?

- The ideal is to mimic optimal implicit contract of Grossman and Van Huyck:
  - Debt restructuring produces contingent debt
  - Borrowing (and fiscal policy) is optimal
- Excusable default is linked to responsible borrowing, to be taken into account by DRF
- Crisis prevention squarely depends on responsible borrowing, as in sustainable fiscal rules
- Therefore use principles of responsible borrowing for eligibility criteria in FSN and for conditionality as appropriate

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