Managing Sovereign Debt Sustainability Risks

Intergovernmental Group of Experts on *Financing for Development*

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- Undoing Quantitative Easing $\rightarrow$ Quantitative Tightening

96) Chart | 97) Set as Default View | Economic Forecasts

Country/Region/World | Contributor | Contributor Composite | Yearly | Quarterly

United States | Browse | Private | Official

Actual / Forecasts | Probability of Recession 15.0%

Indicator	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20
External Balance										
Curr. Acct. (% of GDP)	-2.3	-2.3	-2.2	-2.3	-2.4	-2.5	-2.5	-2.5	-2.6	-2.6
Financial Balances										
Budget (% of GDP)	-3.4	-3.7	-3.7	-3.8	-4.4	-4.7	-4.4	-4.7	-4.9	-5.0
Government Debt (% of GD..			76.9	77.1	77.2	77.7	77.7	78.3	79.3	79.9
Interest Rates										
Central Bank Rate (%)	1.50	1.75	2.00	2.25	2.50	2.70	2.90	3.05	3.10	3.05
3-Month Rate (%)	1.69	2.31	2.34	2.40	2.61	2.79	2.96	3.10	3.17	3.24
2-Year Note (%)	1.89	2.27	2.53	2.82	2.89	3.02	3.13	3.21	3.26	3.31
10-Year Note (%)	2.41	2.74	2.86	3.06	3.17	3.26	3.33	3.36	3.41	3.44
Exchange Rates										
EURUSD	1.20	1.23	1.17	1.16	1.15	1.18	1.20	1.22	1.25	

Multiple sources of risk

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

Sovereign debt contracts

- 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

- **A note on the evidence:**
  - Alesina-Ardagna 2009, "Large Changes in Fiscal Policy: Taxes Versus Spending", analyzed 107 experiences of fiscal austerity and singled out 22 *successful* cases
  - 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

What happens when sovereign debt distress arises?

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

t	3	4	5	6	7
Fraction	0.497	0.525	0.553	0.575	0.6

What happens when sovereign debt distress arises?

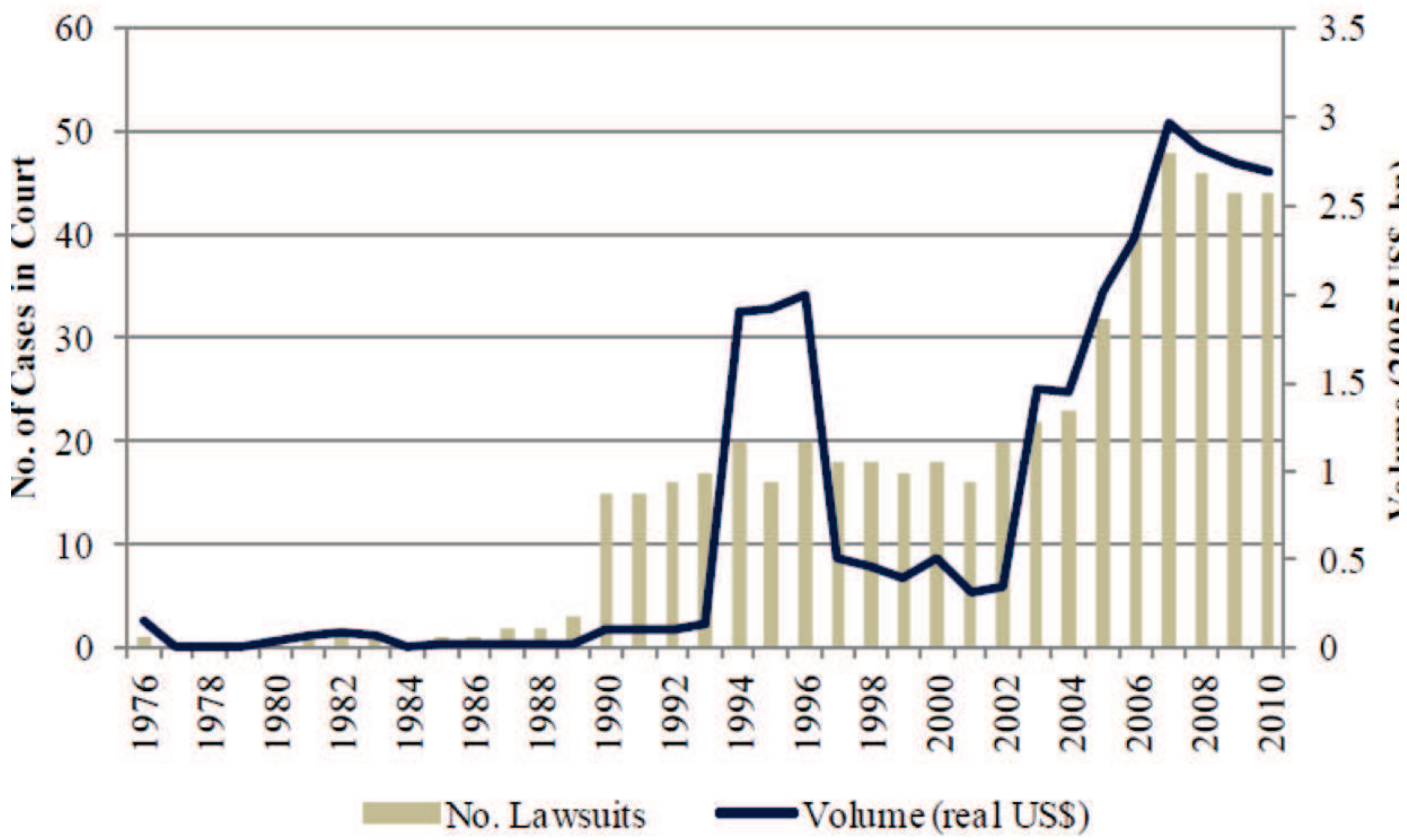
1970-2013: fraction of sovereign debt restructurings with private creditors followed by another restructuring or default within t years

t	3	4	5	6	7
High Income	0.619	0.650	0.700	0.700	0.700
Upper Middle Income	0.500	0.548	0.578	0.590	0.622
Lower Middle Income	0.467	0.477	0.500	0.523	0.548
Low Income	0.455	0.455	0.469	0.531	0.548
Total	0.497	0.525	0.553	0.575	0.6

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)



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

The UN Principles for Sovereign Debt Restructuring

- 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 sustainablity

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)