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New Policy Ideas on Global Sovereign Debt Management

Abstract

In connection with this year's COVID19 pandemic, the issue of sovereign debt moved to the forefront again, mainly, but not exclusively, among low-income countries. Since its introduction, more than seventy countries have already applied for the IMF's emergency facilities. Several states have gone bankrupt, including Argentina and, for the first time in its history, Lebanon. In this environment, the need to create a more integrated international system to handle sovereign defaults re-emerged. There is still no comprehensive global framework, institutional design, or methodology for, e.g., sovereign debt restructuring, although their demand is growing. The main problem is that the absence of the elements mentioned above increases the negotiations' length and uncertainty. Of course, it is incredibly challenging to resolve this issue because of the occasionally heavily politicized negotiations. The interests of developed and lower-income countries are often significantly different, not to mention the existing international organizations. Earlier proposals on this topic have re-emerged again this year, but many new ideas were also conveyed. The study assesses the current situation regarding the pandemic, then synthesizes the old and new suggestions to see more clearly in the "jungle" of proposals on sovereign debt management, focusing on restructuring.

Keywords: sovereign default, external debt, international lending, restructuring

JEL Codes: F34, F65, G28, H63

1. The fiscal consequences of the COVID19 pandemic

The COVID19 pandemic caused a worldwide economic crisis. It hit the real economy and the financial sector as well. The necessary lockdown deepened the downturn, the GDPs contracted, the international trade plummeted, and the unemployment soared. The governments handled the situation mostly with fiscal stimuli. All of these resulted in a worsening fiscal and sovereign debt situation around the globe. The public debt situation was not the best even before the pandemic, and now, especially for the developing countries, a new problem seems to be rising: the debt crisis.

We can observe the Latin American situation (Argentina is the most prominent example) and the still ongoing turmoil in Lebanon, but the countries most hit were the poorest 70%. Most of these economies were fragile anyway, but the epidemic pushed them down even further that road. They will probably be forced to cut government spendings, which means health, education, and other social sectors. Hence, economic growth will be restrained for the following years, with a high unemployment risk. However, of course, the developed countries were hit hard as well. In Figures 1 and 2, we can observe that the effect of the COVID19 Crisis (CVC) was even more significant than the Global Financial Crisis (GFC) in 2008-2009.

Fig. 1. Change in Overall Fiscal Balance (GDP, %)

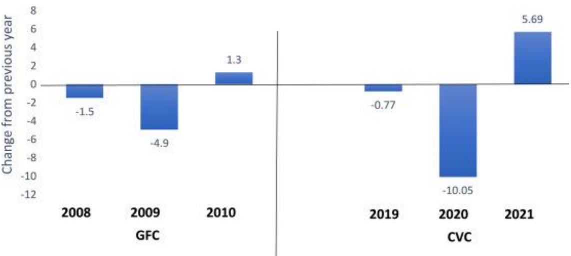
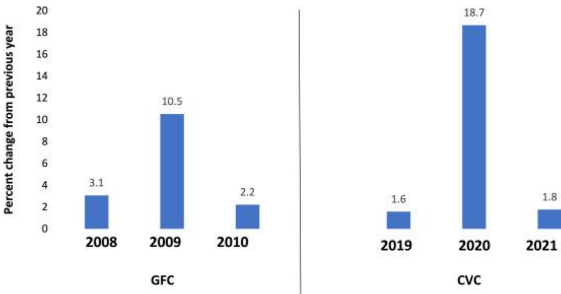


Fig. 2. Change in Government Gross Debt (GDP, %)



Source: Makin-Layton, 2021

The number of countries in debt distress is growing day by day. Currently, the historically low-interest rates prevent a more serious crisis, but this state may not be sustainable for long because of the changing inflationary environment. Certain forecasts (e.g., OECD, 2021a) ratio of government debt to GDP would rise by around 20 percentage points by 2022 on average (among the OECD countries). During peacetime, this means enormous growth. Monetary policy in advanced economies was also prepared for this challenge and took a dovish stance after the pandemic outbreak: interest rate cuts, assets purchase programs tried to keep floating the economies, more or less with success. As a direct consequence, bond yields also reached historically low, sometimes even negative levels. That helped the debt service for the developed countries, although it is questionable how long it can be upheld.

In many states, the official inflation targeting was suspended, and on the fiscal side, the debt or spending ceilings were also put out of effect for this period. Still, even in many developed countries, the pre-pandemic level of public debt was already at historical highs. The emerging economies and low-income countries could not operate with such a wide-ranged toolbox and under such favorable circumstances; thus, the consequences were and possibly will be much direr.

Again, it is noticeable that this crisis has a more substantial influence on the government debt than the 2008-09 GFC. Also, we can see that the debt levels of advanced economies were higher

and grew more than the emerging economies. Still, that does not mean a better situation for the latter because of the circumstances explained above.

2. Measures taken so far

Several steps have been taken, like the "Next Generation EU" recovery plan of the EU (not to mention the intentions of strengthening the rules-based fiscal policies), or the IMF's debt standstills for lower-income countries, the Rapid Credit Facility, which is an option only for low-income (primarily African), and the Rapid Financing Instrument (available to all Member States). Also, the IMF spent a relevant amount through other channels, including existing programs' realignment, e.g., debt service relief for twenty-eight vulnerable countries through the Catastrophe Containment and Relief Trust (IMF, 2020a).

Other vital actions were, for example, the Debt Service Suspension Initiative (DSSI) by the G20. DSSI allowed seventy-three low-income countries to suspend debt service payments on bilateral government loans. With the extension, it is still in effect until the end of 2021. Multilateral development banks offered a standstill for more than a hundred countries. In addition, G20 Finance Ministers agreed on the new issuance of 650 billion Special Drawing Rights, which could be going to low-income countries. After these temporary steps, the Common Framework for Debt Treatment beyond the DSSI will allow "governments with unsustainable debt to enter a restructuring process involving official bilateral creditors, and comparable treatment for private creditors, under an IMF program." (OECD, 2021a).

3. Challenges for the management of the debt crisis

All the actions above serve to avoid sovereign defaults, and they are successful to a certain extent, but the situation is still precarious. The total debt in default started to rise, therefore, the need for a better debt management system is growing.

Of course, we are not at the levels of the European sovereign crisis after the GFC in 2012-13, but it might be even worse if we consider the trend, which was well visible in Fig. 1-2. Hence, it seems that the measures applied so far were insufficient. The causes of this are various.

Some of them are as follows (based on OECD 2021a; Bulow et al., 2020; Stiglitz –Rashid, 2020):

- Private creditors have not engaged with the DSSI. Most notably, China's strategy is diverging from the others.
- Some developing countries have opted out of these programs for fear of seeing their credit ratings downgraded.
- Simply these steps were not enough for certain countries. E.g., the African Union called for extending the DSSI beyond two years where necessary and, in specific cases, for restructuring sovereign debt.
- A significant drop occurred in private funding remittances from emerging market citizens working in other countries (est. 20%).
- New holdout[1] and litigation tactics by private investors to resist significant debt write-downs and restructurings, instead of restructurings, the trend is toward lawsuits. The private sector was successfully maximizing its share in restructurings from the early 1990s.

[1] "The ability of the debtor to repay an individual creditor, or a group of creditors, will improve the more other creditors agree to debt relief. Hence, each creditor has an incentive to hold out for full repayment—that is, free ride on the debt relief agreed by others. This is referred to as the "creditor coordination problem," or alternatively, the "holdout" problem." (Buchheit et al., 2019)

- Another "preexisting" condition is the length (the delay) of "workouts," which is also increasing. Currently, it is around seven years. It helps both sides bargain for additional finance from official creditors.

Based on the challenges above, many old suggestions for better global sovereign debt management surfaced again. Some new ideas are circulating in the scientific, professional, and policy-maker community.

4. Goal of the Study

The study aims to put together and synthesize the ideas, suggestions, and recommendations, which were published after the start of the COVID19 pandemic. After reviewing the literature on the topic before 2020, but since the Washington Consensus, we attempt to accumulate, synthesize and evaluate the suggestions regarding the possible after-pandemic situation. Hence, the methodology will be summarizing and qualitative. The novelty of the study is that there is no such summary so far in the literature.

5. Pre-2020 Literature Review

Since the so-called Washington Consensus (Williamson, 1989) in the 1990s, a vast amount of books and studies were born on the topic (especially after the GFC). Thus a fully comprehensive review is almost impossible to make. Nevertheless, a short review is still worth, because we will observe that many ideas emerging after the pandemic are not new. There is a widespread discussion between the contractual (civil law) and statutory (obligatory central mechanism, governed by an international body, possibly the IMF) approach and their optimal mix. Also, some authors argue that the current, market-based system is adequate, no reform is needed.

Daseking–Powell (1999) gave a broad overview of the effects of the Heavily Indebted Poor Countries (HIPC) IMF initiative on debt reduction mechanisms launched in 1996. Rogoff–Zettelmeyer (2002) argued for Sovereign Bankruptcy Procedures in a study showing a profound historical overview of the idea.

Krueger (2002) and Hagan (2005) set up the framework for a possible new "Sovereign Debt Restructuring Mechanism" (SDRM) under the umbrella of the IMF, based on majority rules and more or less protecting the creditors' interest. The system was mainly designed for bondholder debt (commercial bank and bilateral debt may be included as a separate creditor class). Dodd (2002) also argued for SDRM and collective action clauses (CACs). The proposal was not adopted. In Skeel –Bolton's view (2005) for absolute priority (first in time) in restructuring a global SDRM wherever possible. The authors proposed a two-step classification and voting process for confirming a restructuring plan. The first proposal would be made by the debtor and would suggest the haircut. Suppose a majority of all creditors approves the haircut. In that case, the second step reduces the creditors' claims in this amount, starting with the lowest priority creditors and working up the priority hierarchy.

Rieffel (2003) advocated relying on the existing ad hoc machinery, such as the Paris Club (the London Club disappeared after the Washington Consensus, since the relevance of syndicated loans diminished), to arrange sovereign debt workouts. He also stated that the HIPC was ineffective because no relevant debt reductions were achieved.

Gianviti et al. (2010) designed that a statutory system (they suggest a European Crisis Resolution Mechanism, ECRM) for the EU could reduce most ongoing problems. ECRM would only be for bondholder debt, as the proposal explicitly excludes bilateral and multilateral debt. Stiglitz (2010) suggested a unified sovereign bankruptcy regulation. Paulus (2010) argued for a Standing Arbitral Tribunal (a formalized, standing sovereign debt tribunal) as a procedural solution (arbitration) for sovereign debt restructurings, a new international court. It would work

only upon prior contractual agreement (arbitration clauses should be inserted into the legal documentation). Any kind of external debt could be included.

Raffer advocated an even looser arbitration process (2005) and Kaiser (2013), which they called the Fair and Transparent Arbitration Process (FTAP). FTAP would mean an ad hoc (not standing) arbitration mechanism applicable to all types of sovereign debt. Arbiters would be chosen on a case-by-case basis by creditors, debtors, and the arbiters themselves. FTAP would also include any kind of external debt. Das–Papaioannou–Trebesch (2012) created a wide-ranging survey on sovereign debt restructurings based on the database they constructed. In addition, they discussed ongoing debates on crisis resolution mechanisms, credit default swaps, and the role of collective action clauses. For the detailed comparison between SDRM (ECRM can be considered a narrowed-case for SDRM), FTAP, and a Debt Court (Tribunal). Gitlin–House (2014) proposed Sovereign Debt Forum to coordinate between all private and public creditors. That would be a non-statutory, membership-based forum, like the Paris Club or the London Club (was), to facilitate early engagement among creditors, debtors, and other stakeholders when there is a crisis

In 2013, Buchheit et al. made several policy suggestions for the Euro Area and beyond. They described a number of proposals, ranging from "aggregate collective action clauses" that would give the supermajority of creditors to amend bond payment terms to the amendment of the IMF articles to limit the legal remedies of holdouts when the IMF and the mentioned supermajority of creditors accept it. Brooke et al. (2013) made a case for sovereign "CoCos" (Contingent Convertible debt instruments) to ease liquidity crises. In their paper, the provision of emergency funding by the IMF would trigger a rollover by private bondholders. The authors also advocated the issuance of GDP-linked bonds in case of solvency.

Probably the most surprising results came from the study of Grier–Grier (2020). Regarding the authors' findings, the Washington Consensus worked, it was get rid of early, so it would be worth giving it a second chance. The analysis was based on the data of 49 cases between 1970 and 2015. Hence, that could even count as the first suggestion for a reform: bringing back the system of the 1990s.

6. Major suggestions since the outbreak of the pandemic

Since the outbreak of the COVID19 pandemic, there are several suggestions regarding the sovereign debt situation. In this section, we attempt to synthesize these.

In April 2020, the Centre for Economic Policy Research (Bolton et al., 2020) made a package with many recommendations. Most importantly, they proposed an emergency standstill and a central credit facility (a "CCF") for each country requesting the standstill, administered by a multilateral development bank or the World Bank. This institution would have helped to coordinate it. The standstill happened, but not for all the countries, but these CCFs were not set up.

Bredenkamp et al. (2020) published a very eloquent chapter on the challenges ahead in a comprehensive handbook written about sovereign debt (Abbas–Pienkowski–Rogoff, 2020). They look at the ex ante measures, like fiscal rules, mitigating risks from the financial sector, and debt transparency and responsible lending. They also think that part of the solution is to enhance monitoring capabilities. On the creditor side, they suggest strengthening the existing codes of conduct. As a method of tackling the uncertainty, they also advocate for SCDIs: debt would be linked to GDP or commodity prices; or some discrete adjustment features, like a natural disaster or a pre-defined interest rate. There are some pages (although not many, compared to the size of the book) about crisis resolution as well. The authors introduce the current system briefly, then make proposals on three topics:

1. Changing the law: a statutory framework like SDRM would be desirable.
2. Contract design (contractual approach): CACs with aggregation clauses and a more delicate contractual design to avoid holdout.
3. Strengthening institutions: a Sovereign Debt Forum (see Gitlin–House, 2014).

Stiglitz –Rashid (2020), in their Centre for Economic Policy Research (CEPR) paper, called for urgent actions. They argued for a standstill even in the case of private creditors. Moreover, for stronger CACs, and SCDIs as well. They propose some changes in the major governing laws (e.g., New York) as well. To discourage high-risk lending and holdouts, a tax on excessive returns would be a practical tool. For the protection of social obligations of a public entity (e.g., essential services to the citizens, pensions, etc.), a kind of sovereign bankruptcy regulation (like Chapter 9 in the US) is needed because these need priority over financial claims the private creditors. Furthermore, even sovereign bonds would need a "vis major" (impossibility or impracticability of performance) rule, at least for temporary relief, since nobody could have foreseen, e.g., the pandemic. Regardless of such a clause, the so-called "doctrine of necessity" (an emergency response to an unprecedented crisis) might always play a role in suspending debt payment (like in the case of Greece). As for reducing the debt, the authors bring in the idea of buying back the outstanding sovereign bonds, possibly through securing a "donor buy-in" (e.g., IMF, European financial stability funds, etc.). They propose the immediate establishment of an international facility within the IMF to buy back outstanding sovereign bonds. It has not been established.

The IMF summarized its results in sovereign debt management after 2014 and proposed some reforms (IMF, 2020) in a very comprehensive policy paper. They highlighted the developments involving private-sector creditors since 2014, such as:

- More than twelve sovereign debt restructurings of private claims have been completed, generally smoothly, with shorter average duration and higher creditor participation, mainly due to CACs. In a few low-income countries, though, the process was protracted, incomplete, and non-transparent.
- Debt instruments have become more diverse, including bonds, loans, collateralized debt contracts, and repurchase agreements. The creditor base has also become diverse and more fragmented, and creditor coordination has raised challenges in some recent restructurings.
- Enhanced CACs seem to work well. The so-called two-limb aggregated voting mechanism[2] of these clauses is widespread now and was already used in restructurings. The single-limb voting mechanism[3] has not yet been used, although 90% of international sovereign bonds issued after 2014 have included single-limb aggregated CACs (Buchheit et al., 2019).
- There are targeted statutory tools, such as "anti-vulture fund legislation," in effect in a few advanced economies that complement the contractual approach to sovereign debt restructurings.

[2] The aggregated CAC permits all holders of all series to vote together (instead of the earlier series-by-series voting with 75%) on a proposed restructuring, while also preserving a vote in each series, albeit with a lower voting threshold (66 2/3% as a whole, and 50% series-by-series, provided that 85% of all affected series approved the exchange). It is more difficult for a holdout creditor to accumulate a blocking position.

[3] Single-limb CACs need only a single vote calculated on an aggregated basis across all affected bonds. By eliminating the requirement of a series-by-series vote (i.e., the second limb), a single-limb voting procedure removes the possibility of obtaining a controlling position within a particular issuance to block the restructuring of that issuance.

The policy paper makes several suggestions for enhancing the resolution toolkit:

1. The would augment the current contractual approach to limit holdout behavior by using trust structures and including majority restructuring provisions for payment terms in loan agreements. State-contingent features may help deal with uncertainty and protect the sovereign from downside risk. The IMF published many papers on state-contingent debt instruments (SCDIs)[4] (E.g., Cohen et al., 2020 or Guerson, 2021), so it is a strong advocate for them.
2. IMF is very ambiguous on the question of "anti-vulture fund" legislation. They think these can raise important legal and policy issues, so they have to be carefully tailored to accomplish their objectives.
3. IMF and other international financial institutions (IFIs) could provide limited financing that would allow debtors to offer cash and/or credit enhancements in the context of a deep debt restructuring operation, facilitating agreement on a debt deal.
4. The international community should support debt transparency and help countries strengthen their debt management capacity ex-ante, including technical assistance.
5. If a COVID-related systemic sovereign debt crisis materializes, the current resolution toolkit may not be adequate to address the crisis effectively. Hence additional tools will be needed at short notice. Since contractual reforms would require time to become effective, such instruments could only be either of a financial or statutory nature.

Another set of ideas came from the OECD (2021a). According to the OECD, the policy toolbox should be widened beyond low-income countries, suggesting the expansion of the HIPC initiative. It means other developing (such as most Latin American states) and many middle-income economies are not eligible for G20 initiatives and whose lenders are mainly from the private sector. The OECD advocates for three policy actions (OECD, 2021a):

1. Ensuring sufficient liquidity for solvent but vulnerable countries;
2. Streamlining debt-restructuring processes when necessary;
3. Across all borrowing countries, improving debt management frameworks, transparency, and accountability.

7. Conclusion and future research

The shock caused by the pandemic also provided an opportunity for the decision-makers to think over the current architecture of sovereign debt restructuring. The possibility of debt crises brought back many old proposals in new versions. Everybody agrees on enhancing the ex-ante toolkit with more transparency, better forecasts, and credit assessments. About the ex-post mechanisms, though, the discussion is as heated as ever. The majority of the papers propose upgrading the existing contractual framework but more and more suggest creating unified statutory institutions and rules for default. The dispute is ongoing, but a better sovereign debt "workout" is in the interest of all. For sure, it would take time to establish a new statutory system, sovereign debt restructuring mechanism, but in the long run, it would be worth it. A goal of future research could be to analyze the viability of the old and new proposals. Whether they are feasible and acceptable in the current creditors' environment or not.

[4] State-contingent debt instruments (SCDIs) link a sovereign's debt service payments to its capacity to pay, where the latter is linked to real world variables or events.

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