Efficient Resolution of Sovereign Debt Crises

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Expert Group Meeting of the UN ESCAP on Public Debt and Sustainable Financing in Asia and the Pacific

November 28-December 2, 2022, Bangkok

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Key ingredients of efficient sovereign debt resolutions

1. **Timely recognition of the debt problem.** Early action by the debtor – e.g., pursuing a preemptive/pre-default restructuring – generally means less costly resolution.

2. **Credible sizing of the problem.** Debt sustainability analysis is key

3. **Effective creditor engagement**
   - Debtor-creditor engagement
   - Creditor-creditor engagement

4. **Innovative instruments to close the deal.** Can bridge differences between debtor and creditors on macroeconomic outlook

1. Timely recognition of the debt problem

- Large literature has documented the **too-little too-late** problem in sovereign debt restructurings. [IMF, 2013: *Sovereign Debt Restructuring—Recent Developments And Implications For The Fund's Legal And Policy Framework*]
- **"Too late" problem particularly persistent –** both for analytical and political reasons (see chapter on "Sovereign Default" in *Sovereign Debt: A Guide for Economists and Practitioners*)
- **Analytical:**
  - Not easy to say when a sovereign has **reached that point** where adjustment and liquidity provision would not be enough, and debt relief from creditors is necessary.
  - **Spreads** usually provide good signal but can be volatile in some circumstances; sovereign **ratings** are often late.
  - Good sovereign risk and **debt sustainability models** can help, e.g., the IMF, 2022: *Sovereign Risk and Debt Sustainability Framework for Market-Access Countries*
- **Political:**
  - Costly for incumbent government or finance minister to declare that the sovereign needs to restructure its debt. Incentives to **gamble for resurrection** are very high.
  - Governments will often try to **hide the problem** (by shifting losses off the books), pursue risky means (collateralized borrowing), or costly market financing with put options. Makes the problem worse, and coupled with the delay, makes the solution more difficult (as larger contributions must be negotiated with creditors)

2. Credible sizing of the debt problem

- Assuming decision to restructure has been taken, key questions:
  - How will **GDP and market access** evolve during and after restructuring?
    - Avoid excessive optimism on GDP path; excessive pessimism on market re-access.
  - What is the limit of **feasible fiscal and external adjustment**?
    - Avoid overestimating political will to implement difficult adjustment, esp. in a recession. But a too shallow adjustment will complicate negotiations with creditors
  - How much **financing** is available?
    - Ensure IFI liquidity support is not wasted on bailing out creditors. There are merits to reprofile early to conserve financing
  - What is the required **contribution from creditors**?
    - Early/coordinated signal from official creditors on debt relief, agreed with the Fund, can help define contribution needed from private creditors
- The Fund, through its **debt sustainability analysis (DSA)**, plays a key role in sizing the envelope of debt relief, and by setting debt sustainability targets in terms of medium-term debt/GDP, debt service ratios, and gross financing needs/GDP.

3a. Effective creditor engagement: debtor-creditor

- Important for sovereign debtors to understand **differences between creditors**.
  - In the assumed **creditor hierarchy**, official bilateral creditors rank above private creditors. Indeed, the Paris Club has traditionally required comparability of treatment from private creditors.
  - In practice, governments are **averse to approaching private creditors**, even for a light-touch reprofiling, because they fear losing market access (rating agencies also invariably focus on credit events around private bondholders); or where there are broader concerns about the domestic financial system.
  - Thus, governments invariably ***first*** **pursue official bilateral creditors** to either reschedule claims or provide new financing to help meet maturing obligations; and leave approaching private creditors as a last resort.
  - This said, in a situation where a government has announced that it is seeking debt relief from both official bilateral and private creditors, **private creditors are likely to provide deeper/more upfront relief** than official creditors, who prefer rescheduling/refinancing.
- The **sovereign debtor's "good faith"** is key.
  - Asking for overall contribution not in excess of what is "needed" (as defined by DSA); and seeking (broadly) comparable contributions from creditors within creditor group (see IMF, 2022: *Reviews of The Fund's Arrears Policies and Perimeter*)

See chapter on "The Debt Restructuring Process" in *Sovereign Debt: A Guide for Economists and Practitioners.*

3b. Effective creditor engagement: creditor-creditor

- **Processes for official bilateral creditors**

  - **Paris Club** well established
  - **Common Framework (CF) becoming more relevant** in an era of large non-Paris Club claims, where broader coordination is needed, but is still experiencing some growing pains (just one case--Chad—completed thus far)

- **Processes for private creditors**

  - **Contractual approach** (i.e., use of enhanced collective action clauses in debt contracts) is becoming well-established as more and more debtors use recommended clauses, plus new initiative on majority voting provisions (MVPs) in syndicated loans.
  - But there are still **vexing issues** around
    - Equitable treatment of external vs. domestic private creditors,
    - Collateralized debt
    - Lingering ability of vulture funds to hold out where contractual gaps still exist.

The rise of ***creditors and instruments that straddle both processes*** *is a complication.*

See IMF, 2020: *The International Architecture for Resolving Sovereign Debt*
IMF, 2021: *Issues in Restructuring of Sovereign Domestic Debt*

4. Innovative instruments to close the deal

- Usually, **creditors are more optimistic** about the macroeconomic outlook, which they will use to argue for lower debt relief
- Debtors, on the other hand, will usually want to be conservative on the outlook, and commensurately larger debt relief, so that they do not end up with a **“too-little”** problem.
- The **Fund’s DSA** will narrow this difference, but not eliminate it.
- Enter ***state-contingent instruments***:
  - Can offer **upside return** to creditors if macro turns out better than expected.
  - Needs to be designed carefully to **cap the upside**.
  - **Downside protection** may also be important, where sovereign is exposed to large shocks, such as natural disasters.

See IMF, 2020: *The Role of State Contingent Debt Instruments in Sovereign Debt Restructurings*

Thank you, and please do check out:

Sovereign Debt: A Guide
for Economists and Practitioners,
Oxford University Press, 2021

Chapters:
1. Public Debt through the Ages
2. Concepts, Definitions and Composition
3. The Motive to Borrow
4. Public Debt Sustainability
5. Debt Management
6. Reducing Debt Short of Default
7. Sovereign Default
8. The Restructuring Process
9. Challenges Ahead