

CRISIS RESOLUTION AND INTERNATIONAL DEBT WORKOUT MECHANISMS

Presentation made by

Yılmaz Akyüz

Chief Economist, South Centre, Geneva

At the

UN Ad Hoc Committee on a Multilateral Legal Framework for Sovereign Debt Restructuring Process

5 February 2015, New York

International Debt Workout Mechanisms

- Debt restructuring is a component of crisis management and resolution; needs to be treated in the context of the current economic conjuncture and vulnerabilities.
- IDWM are not just about debt reduction, but include interim arrangements to provide relief to debtors including temporary hold on debt payments and financing.
- IDWM should address liquidity as well as solvency crises. Difference is not always clear. Most start as liquidity crises and can lead to insolvency if not resolved quickly. Liquidity crises also inflict serious social and economic damages as seen in the past two decades even when they do not entail sovereign defaults.
- IDWM should apply to crises caused by external private debt as well as sovereign debt. Private external borrowing is often the reason for liquidity crises. Governments end up socializing private debt. They need mechanisms that facilitate resolution of crises caused by private borrowing.
- IDWM apply to legal not economic concept of external debt. Legal concept: debt issued under foreign jurisdiction irrespective of its currency of denomination and holders. Economic (Balance of Payments) concept: debt held by non-residents irrespective of the law it comes under and its currency denomination.

- Local-law debt should not come under IDWM even when held by non-residents. This was agreed during the debate on the Sovereign Debt Restructuring Mechanism (SDRM) in the IMF in the early 2000s. For such debt governments have the means to resolve collective action problems.

Recent Crises and Current Vulnerabilities

- Only one of the last 8 major crises in emerging and developing economies (EDEs) was due to internationally-issued sovereign debt (Argentina). Mexican and Russian crises were due to locally-issued public debt (tesobonos and GKO); in Asia (Thailand, Korea, Indonesia) external debt was private; in Brazilian and Turkish crises too private (bank) debt played a key role alongside some problems in domestic public debt market.
- We have had no major new crisis in the South with systemic implications for over a decade thanks to highly favourable global liquidity conditions and risk appetite, both before and after the Lehman collapse, due to policies in major advanced economies, notably the US. But this period, notably the past six years, have also seen considerable build-up of fragility and vulnerability to liquidity and solvency crises in many EDEs (see [SC Research Paper 60](#)). This is a matter for concern because favourable global financial conditions are unlikely to last over the coming years.
- Sovereign international debt problems may emerge in the so-called frontier economies usually dependent on official lending. Many of them have gone into bond markets in recent years, taking advantage of exceptional global liquidity conditions and risk assessments. There are several first-time Eurobond issuers in sub-Saharan Africa and elsewhere.
- In emerging economies (EMEs) internationally-issued public debt as % of GDP has declined significantly since the early 2000s. Much of external debt (in BOP terms) of these economies is now under local-law and in local currency. However, there is a

large build-up of private external debt in forex issued under foreign law since 2008. Many of them may face contingent liabilities and are vulnerable to liquidity crises.

Crisis Intervention

- Interruption of access to international financial markets, stop in capital flows, foreign exit from local financial markets and capital flight by residents resulting in rapid depletion of reserves, currency collapse and interest rate hikes; governments often too late to recognize the gravity of the situation.
- IMF lending is typically designed to bail out creditors – to keep debtors current on their obligations to creditors – and to avoid exchange restrictions and maintain the capital account open.
- The IMF imposes austerity on the debtor, expecting that it would make debt payable and sustainable and bring back private creditors. It has little leverage on creditors.
- Problems with standard crisis intervention: austerity can make debt even less payable; creditor bailouts create moral hazard and promote imprudent lending, and transform commercial debt into official debt, thereby making it more difficult to restructure; and creates risks for the financial integrity of the IMF.
- Many of these problems were recognized after the Asian crisis, giving rise to the SDRM, originally designed very much along the lines advocated by UNCTAD throughout the 1980s and 1990s (though without due acknowledgement). However, it was opposed by the US and international financial markets and could not elicit strong support from debtor EDEs, notably in Latin America. It was first diluted and then abandoned.
- The question of IDWM was put on the back-burner after the early 2000s as strong global growth, unusually favourable conditions in international financial markets and

rapid recovery of capital flows to EDEs led to complacency and served to obscure continued weaknesses and vulnerabilities in several EDEs. The matter has come back to the attention of the international community with the Eurozone crisis and then with vulture-fund holdouts in Argentinian debt restructuring.

A New IMF Proposal

- After pouring money into Argentina and Greece whose debt turned out to be unpayable, the IMF has proposed a new framework to “limit the risk that Fund resources will simply be used to bail out private creditors” and to involve private creditors in crisis resolution.
- The proposed intervention and crisis resolution would be different according to how the problem facing the country requesting IMF assistance is perceived.
- Where debt is deemed to have a high probability of sustainability, the IMF would lend as usual, under the exceptional lending framework of 2002, while the country would make policy adjustments.
- If debt sustainability looks uncertain, the IMF would require re-profiling (rollovers and maturity extension) before lending. If debt turns out to be unsustainable at the end of the IMF programme, then restructuring (debt relief) would be sought.
- If debt is seen as unsustainable with a high probability, the IMF would require upfront debt reduction before lending.

Problems with the New Proposal

- The proposed shift of the IMF away from creditor bailouts is welcome. But for several reasons the proposal does not provide a viable and reliable IDWM.

- The IMF does not have a good record in sustainability assessments but wants to pass judgement on whether or not a country approaching it for assistance is solvent and needs reprofiling and restructuring. These decisions should mainly be left to the country concerned.
- There is no legally binding framework for reprofiling and restructuring. They are left to negotiations between the debtor and the creditors, to be facilitated by various contractual provisions.
- Re-profilng needs to be done quickly to prevent meltdown. This could be possible when debt is mainly in syndicated bank credits, but not when it is in widely dispersed bonds. Even in what is widely considered as successful instances of negotiations, agreements with banks in Korea, Brazil and Turkey came only after the deepening of the crisis as banks were interested in exiting quickly rather than rolling over their claims. Thus, in a statement at a G20 meeting, Korea hinted its agreement with many observers who "have found that Korea could have solved its liquidity problem sooner had a standstill programme been in place at the time Korea requested IMF assistance at the end of 1997"
- If creditors fail to agree to reprofile and restructure and the IMF does not lend without these, then it would effectively be telling the debtor to default.
- But it makes no proposal to protect the debtor against litigation and asset grab by creditors.

Reform and Limits of Contract-Based Resolutions

- The IMF and others have been making proposals for improving debt contracts by inserting better-designed CACs, stronger *pari passu* clauses etc. in order to facilitate negotiated settlements. There is a growing consensus that this route needs to be explored further in resolving liquidity and solvency crises.

- However, there are well recognized limits to what negotiations can achieve. These have been discussed extensively in the past two days and a half in this meeting and I do not want to repeat them here.
- A viable solution could be to rely on a judicious combination of contractual and statutory arrangements in different stages of crisis resolution.

Elements of a workable IDWM

- Statutory reprofiling: Need for temporary debt standstills and exchange controls whether it is liquidity or solvency crisis or is caused by public or private debt. Decision to be taken by the country concerned and sanctioned by an internationally recognized independent body to impose stay on litigation.
- Lender-in-possession financing: sanctioning standstills automatically grants seniority to new loans, to be used for current account financing, not to pay creditors or finance capital outflows. The IMF should be required to lend into arrears, but the private sectors can also be motivated to lend if terms are favourable since such lending would enjoy *de jure* seniority. In any case there would not be much need for new money since debt standstills and exchange controls limit the drain on reserves and the policy adjustment by the country can be expected to improve the current account.
- Negotiated debt restructuring including maturity extensions, rollovers etc, aided by CACs and other measures designed to restrain holdouts. If financial meltdown is prevented through standstills and exchange controls, stay is imposed on litigation, adequate lender-in-possession financing is provided and contractual provisions are improved, the likelihood of reaching a negotiated debt workout would be very high in large majority of cases. A statutory cram-down should be the last resort. It should be recognized that a statutory solution would intervene not only with creditors' rights but also with sovereign rights of debtor countries. In this respect the pros and

cons of various options (international bankruptcy courts, *ad hoc* panels, arbitration, and a dispute settlement system along the lines of the WTO) should be carefully assessed.

Role of the IMF and the United Nations

- The role of the IMF in crisis management and resolution is incontrovertible. However, the IMF cannot be placed at the centre of IDWM. Even after a fundamental reform, the IMF Board cannot act as a sanctioning body and arbitrator because of conflict of interest; its members represent debtors and creditors.
- However, independent statutory bodies and mechanisms can be established within the IMF (as in WTO) if its governance is significantly reformed.
- The United Nations successfully played an important role in crisis resolution in several instances in the past.
- The Compensatory Financing Facility introduced in the early 1960s to enable developing countries facing liquidity problems due to temporary shortfalls in primary export earnings to draw on the Fund beyond their normal drawing rights at concessional terms resulted from a UN initiative.
- Guidelines for negotiations of official and officially guaranteed debt of developing countries were effectively set at UNCTAD in 1980 through the adoption of TDB Resolution 222(XXI) which was seen by Michel Camdessus, the chairman of the Paris Club at the time, “as establishing the international legitimacy of the Paris Club within the international financial architecture.”
- A more recent example concerns Iraq’s debt. After the occupation of Iraq and collapse of the Saddam regime, the UN Security Council adopted a resolution (No 1483) to implement stay on the enforcement of creditor rights to use litigation to

collect unpaid sovereign debt. This was engineered by the very same country, the United States, which now denies a role to the UN in debt and finance on grounds that it lacks competence on such matters that mainly belong to the Bretton Woods Institutions.

- More interestingly, that Security Council resolution on Iraq's debt was duly complied with and implemented by the very same institutions, the IMF, World Bank and the Paris Club, which have refused to participate in these deliberations mandated by the General Assembly, presumably because they would not want to take guidance from the UN on debt restructuring.

Yılmaz Akyüz.
New York,
5 February 2015