Economic and Social Council

Special meeting on
"External debt sustainability and development: Lessons learned from debt crises and ongoing work on sovereign debt restructuring and debt resolution mechanisms"

ECOSOC Chamber, 23 April 2013

CONCEPT NOTE

Mandate

The General Assembly, in its resolution 67/198 on "External debt sustainability and development", "*Invites* the Economic and Social Council to hold a one-day meeting in 2013, in conjunction with its special high-level meeting with the Bretton Woods institutions, the World Trade Organization and the United Nations Conference on Trade and Development, to consider lessons learned from debt crises and the ongoing work on sovereign debt restructuring and debt resolution mechanisms, with the participation of all relevant stakeholders, and also invites the President of the Economic and Social Council to prepare a summary of the meeting" (para 28).

Background

History is replete with episodes of boom and bust cycles and hundreds of defaults and rescheduling. It is true that eventually there is some kind of settlement between creditors and the debtor country is reached – the question is at what cost? Debt restructurings can have drastic adverse consequences for economic growth, trade, capital flows, banks and other financial institutions. The social costs of debt crises are also an area of major concern. Sovereign debt crises can threaten financial, economic and political stability. In this respect, recent economic history is replete with examples of how the loss in output from debt crises affects the poor in developed as well as emerging markets and developing regions. Moreover, the costs —to both the sovereign debtor and its creditors — associated with debt problems mount with delays in addressing debt overhangs, with attendant risks to global financial stability and adverse implications for capital markets.

Many gaps in the financial architecture for debt restructuring were evident in the experience with sovereign debt crises in emerging markets and other developing countries since the mid 1970s. There are valuable lessons learnt from these experiences but efforts to reform the architecture have been slow and the incremental steps taken have been inadequate in providing a timely and cost-effective debt crisis prevention and resolution. The challenge of preventing and managing sovereign debt crises has taken on a new urgency in the wake of the global financial crisis. Many of the countries currently struggling with high public debt burdens are in the developed world, making the problem of excessive sovereign debt a global phenomenon and a threat to international financial stability. The sheer magnitude of the global problem now involving developed countries is reflected in the large scale bailouts by the official sector to some European countries, the size of which is a first in economic history.

The debate on the architecture for sovereign debt restructuring is not new. A decade ago, on the heels of a series of debt crises in many countries in Latin America and the Asian financial crisis, the international community explored a range of possible options to facilitate timely, orderly restructuring of sovereign debt. The objective of those discussions was to augment the international adjustment toolkit in cases where debt burdens had become so high that they were widely viewed as unsustainable and possibly posed a risk of distorting the incentives to pursue sound macroeconomic policies, with spill over effects to neighbouring countries and the global economy more broadly. These efforts to develop a better framework for the timely, orderly restructuring of sovereign debt were marked by a divergence of views between those prepared to support so-called "voluntary" approaches, in which bondholders would accept contractual modifications that facilitated restructuring, and those who supported a more formal, statutory approach—the Sovereign Debt Restructuring Mechanism (SDRM)—as developed by the IMF. A lack of adequate buy-in by stakeholders led to the demise of the statutory proposal, and the decision was taken to abandon statutory approaches and efforts were directed at the inclusion of collective action clauses (CACs) in new bond issues of key emerging market economies.

The discussion went into a decade long hiatus as a result of the ample global liquidity and the benign global environment that preceded the global financial and economic crisis. The debt problems in low income countries were dealt with special approaches to deal with their special situation. The complacency both in policy circles as well as amongst the private sector has been shaken up with the ongoing debt crisis of Eurozone members to force the recognition that debt problems can pose a systemic risk, and the need to revisit the question of debt crisis and the architecture for debt crisis prevention and resolution squarely back on the international agenda. There is an increasing recognition that the status quo is costly for everyone.

Traditionally, bailouts for countries experiencing a debt crisis have been accompanied by adjustment through fiscal and exchange rate policies. But in a world of liberalized capital markets, timely solutions to external adjustment also entails debt restructuring, as the growing experience with debt problems points to the limits of austerity measures. This issue is central to the role of the International Monetary Fund (IMF) in assisting its members strike a judicious balance between financing and adjustment. The danger is that, faced with the prospect of draconian fiscal adjustment or disorderly default, governments will prevaricate, increasing the eventual costs of adjustment to debtor government citizens as painful but necessary adjustments are deferred. Private creditors, whose asset values will deteriorate through the subordination of their claims, may also be made worse off. In this situation, the IMF experiences a potential loss of credibility and legitimacy, as its members are ultimately required to undertake painful adjustments that are inconsistent with the Fund's basic mandate.

In this respect, the existing structure for restructuring sovereign debt is not ideal, and while the inclusion of collective action clauses (CACs) in bond contracts and the development of a voluntary code of conduct to guide sovereign debt restructuring negotiations represent an important step forward, they have not eliminated the need for a better framework for the restructuring of sovereign debt. CACs can play an important role in facilitating debt restructurings. However, their presence is no guarantee for a quick debt exchange with high participation. Other legal vehicles and exchange characteristics can play an important role as well, in particular exit consents, aggregation clauses, and minimum participation thresholds.

Solutions have often been accompanied by undue lags and, for the most part, have provided too little relief, often leading to future debt restructurings, jeopardizing the resumption of growth and prospects for keeping debt sustainable. This, in turn, may result in unilateral debt reductions with possible loss of access to international capital markets or punitive costs of raising new money. The official sector has in recent times played an increasingly bigger role in bail-outs. There are limits of providing support from public sector funds, which can result in the mispricing of risk, and it is timely to discuss exit strategies for the public sector.

Questions for discussion

The ECOSOC event will centre on the lessons learned from debt crises and a discussion around the ongoing working on sovereign debt restructuring and debt resolution mechanisms in the United Nations system, with the participation of stakeholders. The discussion aims to find clarity on some of the following issues:

- What are the legal and institutional gaps in the architecture for sovereign debt restructuring?
- What are the costs of debt crises?
- What are the lessons learned from the history of debt crises?
- Is the evolution in the voluntary approach sufficient to deal with debt crisis?
- What should be the roles of the official and private sector in managing a debt crisis?
- What are the options for improving the architecture for more efficient outcomes under the voluntary and statutory approaches?