Report of the Panel on Facilitating International Adjustment through Timely Debt Resolution

Financing for Development Office,
United Nations Department of Economic and Social Affairs
The Centre for International Governance Innovation

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The Financing for Development Office (FfDO), Department of Economic and Social Affairs, United Nations, together with the Centre for International Governance Innovation (CIGI), Canada hosted a panel discussion on "Facilitating International Adjustment through timely debt restructuring" at the IMF-World Bank Annual Meeting in Tokyo on 12 October. The panel featured an impressive group of speakers drawn from academia, the private sector and official sectors:

Shamshad Akhtar (Assistant Secretary General, Department of Economic and Social Affairs, United Nations)

Jose Antonio Ocampo (Professor of Professional Practice in International and Public Affairs, Columbia University)

Sergei Storchak (Deputy Finance Minister, Russian Federation)

Barry Eichengreen (Professor of Economics and Political Science, University of California, Berkeley)

Willem Buiter (Chief Economist, Citigroup)

Robert Gray (Chairman, Debt Financing & Advisory Group, HSBC Bank),

Amar Bhattacharya (Director of the Secretariat, Intergovernmental Group of Twenty-Four).

The panel was co-moderated by *Benu Schneider* (Chief of External Debt and Development Finance Unit, UNDESA) and *Paul Bluestein* (Senior Fellow, CIGI).

The event built on two expert group meetings held in May and September respectively that were organized by the FfDO and CIGI. The objective of the Tokyo panel was to assess the extent to which a consensus exists on how best to promote an improved system for the restructuring of sovereign debt in order to reduce the high costs for debtors, creditors and reduce the risk of a systematic crisis

Summary of Panel Discussion

Panelists agreed that the best way forward for debt restructuring is one that maximizes the chances of debtors to regain access to private capital markets and resume growth. Evidence with past debt restructuring suggests that too much time is lost in a restructuring and the challenge to make the process more efficient has been with us for a long time. The IMF proposal for a Sovereign Debt Restructuring Mechanism (SDRM), which would have created a framework for structured negotiations and restructuring, did not gain wide support amongst the IMF's membership, and the private sector, because the element in the proposal for mandatory stays. In this regard, the challenge has always been of not making debt restructuring too easy or too hard. In a sense, this is about balancing incentives to repay debt (preserve its bonding role) and incentives not to "defect" from the open international trade and payments system.

While valuable lessons have been learned from past history of debt distress and defaults, some panelists argued that efforts in this area have fallen short of the policy initiatives needed to reform the architecture for debt restructuring. Countries in need of a sovereign debt workout continue to rely on an ad hoc process that remains incomplete, messy and in which stakeholders must try to "muddle through." The existing process, some argued, is creditor driven, and that efforts are needed to get fair treatment between creditors and debtors and reduce the time and costs involved.

Reflecting on the progress with the inclusion of collective action clauses in bond contracts, the panel recognized that the inclusion of CACs in bond issues was motivated by a desire to avoid a mandatory SDRM that could stay litigation and facilitate a cram down of a restructuring proposal acceptable to a supermajority of creditors. In this respect, the SDRM debate alerted creditors to the vulnerability of their position: Given the sovereign's ability to suspend payments through *force majeure*, and the difficulties of enforcing judgments under the doctrine of sovereign immunity, creditors' leverage comes from the power to litigate.

There was consensus in the panel regarding the benefits of Collective Action Clauses (CACs) in terms of facilitating creditor coordination, while recognizing the limitations of what CACs can do. Most significant of these limitations is the problem of aggregation: CACs could secure a timely restructuring of an individual bond issue, but in the absence of some mechanism that also addresses other bond issues (and other debts), investors would be loath to accept a reduction in their claims refitting the contracts with aggregation clauses for creditor coordination across a series of bond issues; absent a restructuring in the aggregate, individual bond issues would not be likely. Some of the limitations of CACs led to the evolution of the Code of Conduct in the IIF Principles for Stable Private Capital Flows. Although the code of conduct is intended to promote a

dialogue between creditors and the borrower, the experience with debt problems has revealed that the Code of Conduct does not have real traction, and cannot produce the results required -- a downward trend in risk premia and greater growth.

One of the major problems of voluntary restructurings is the potential for serial restructurings. Some panelists expressed the view that this would likely be the case with respect to Greece, although European governments are now major creditors. In this regard, it was noted that problem has been shifted from the private sector to European governments. The Greek restructuring could, it was argued, illustrate the advantages of a statutory approach to the private sector: —while the horizontal inequities amongst creditors is a problem for them, so too are the inequities between official and private creditors. In the Greek restructuring not all official creditors engaged in restructuring.

A proposal for combing the voluntary and statutory approach was outlined which would allow for voluntary debt restructuring "in the shadow of the courthouse." This could be a version of the dispute settlement mechanism of the WTO, a system in which there are panels of experts. These experts would- not be drawn from the IMF staff, although the IMF could be mobilized as the convening power. The process would be modeled on, the WTO dispute settlement mechanism. In the first stage, negotiations would be voluntary and subject to a deadline. If no agreement is reached, the second stage could be a panel, which would serve as an arbiter. If agreement is still lacking, the panel would settle the dispute with a decision which would be binding on all. Because the proposal includes all creditors, including new creditors, official export agencies and development banks, IMF and MDBs, this approach could assuage the fears of the private sector that they alone would be forced to accept "haircuts" while other private and official sector creditors would escape unscathed.

It was suggested that long-term portfolio investors and foreign direct investment gain in a scheme that is statutory in nature. If debt is bought in the secondary market, for example, it should not have any preference in debt restructuring, in contrast to the *status quo* in which more liquid short-term debt that is more likely to be favored in official sector interventions.

Furthermore, it was argued that the IMF should play a clearer role when there are inflows of capital despite the reluctance of governments to control capital inflows. There is, clearly, no point in closing the floodgates when the capital has left. One of the central problems that must be addressed in the system is the fact that official resources can be used to finance the exit of capital. In this respect, the changing nature of the origins of sovereign debt problems has to be recognized. In the beginning in the 80s, it was noted, sovereign debt problems reflected direct borrowing by the sovereign and macroeconomic

policies and vulnerabilities, as was also the case of the HIPC countries. We are now increasingly seeing a different origin of the crisis—a lethal combination of private capital flows leading to credit booms as witnessed in East Asia leading to large scale socialization of the costs. This type of crisis is now unfolding in Europe. Thus, preventing and better managing sovereign debt problems requires *ex ante* measures to prevent excessive borrowing and the accumulation of fragile debt structures (debt contracted at shorter-terms and in foreign currency), and the development of a better debt resolution mechanism for *ex post* restructuring. In this respect, it was suggested that the IMF has not raised enough of a "red flag" in warnings of possible excessive borrowing. At the same time, there is an important role for the public sector to avoid surges in capital inflows and governments could also play an important role in making GDP-linked bonds an instrument to pursue counter-cyclical policies.

In a debt crisis, a balance is needed between restructuring, financing, and adjustment. Who's going to call that? While panelist agreed that only the IMF can play this role, the role of honest broker has to be institutionalized.

Panelists agreed that early engagement between creditor and debtors is a good thing, but that there are many obstacles. Creditors may be unable or unwilling to coalesce into one team; depending on the composition of the creditor community disparate creditor teams could form. Given these obstacles, a permanent committee that facilitates early communication between the debtor and a broad range of creditors could help promote timely and orderly restructurings. Another step could be to get debtor agreement to negotiate with a properly constituted body. The objective here is to avoid situations in which debtors adopt legalistic positions on which creditor group they are prepared to negotiate with as valid counterparties to the debtor. This illustrates the need for improvement in setting up an improved platform which could improve the conditions for debtor and creditor engagement. The role of endorsing the validity of a group of creditors can possibly be done by the IMF. At the same time, it was noted that there is a risk that creditor committees can become creditor cartels that promote intransigence and delay restructurings.