



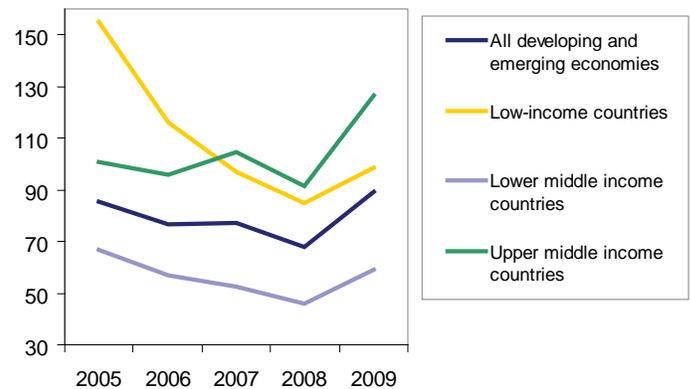
## Till Debt do us Part: the Urgency of a Sovereign Debt Workout Mechanism

The danger to global economic recovery posed by the European debt turmoil throws a spotlight on a key missing international institution critical to global finance—a sovereign debt resolution mechanism.<sup>1</sup>

The morphing of the global financial crisis into dangerous debt dynamics finds its leading edge in the developed economies in Europe, including Greece and other parts of Southern Europe. In addition, the IMF and the World Bank have classified 11 low-income countries as in debt distress, with another 16 at high risk of distress. After a few years of stable debt burdens, the crisis is seeing debt burdens of “upper middle income” countries rising noticeably (Figure 1), portending possible difficulties in the future if the global economic growth rates remain weak.

The risk of sovereign debt crises is heightened by the lack of a framework for resolving sovereign debt distress in an orderly manner. The existing approaches to restructuring both official and private sector lending to sovereigns are ad hoc and piecemeal. Sovereign debt workouts have been inefficient, costly, and incomplete, and, in many cases, have not provided enough debt relief to give debtor countries a “fresh start” (or the ability to grow and undertake appropriate social and economic development expenditures following insolvency). The existence of a debt overhang thus continues to depress growth after the restructuring, often leading to the need for additional write-downs in the future. Paris Club workouts between low-income countries and official creditors have been particularly prone to repeat or ‘serial’ restructurings, but the problem also exists for highly indebted emerging market countries that primarily borrow from the private sector.

Figure 1. External debt (percentage of exports)



Source: MDG Gap Task Force Report 2010: *The Global Partnership for Development at a Critical Juncture*

### Getting in debt trouble with private creditors

Two very different types of workouts have been used to restructure market-based sovereign debt. Some countries, such as Argentina and Russia, defaulted unilaterally in extremely disorderly restructurings that were associated with high welfare losses. The risk of these types of unilateral default has led to panicked exits on the part of private creditors in response to early signs of debt distress. Other countries developed a set of ad hoc solutions, including market-based debt exchanges and collective action clauses in bond contracts. These measures did lead to an increased number of quick and somewhat orderly restructurings. Yet, an orderly workout without undue delay, while important, is not the only goal of a bankruptcy regime. Equally important goals are an equitable solution and a ‘fresh start’ for the debtor country. These mechanisms can be seen as useful rollover operations to manage liquidity problems, but they do not address sovereign insolvency when debt levels are unsustainable.

In addition, market-based workouts have not necessarily led to equitable solutions. In today’s complex global economy, a country’s creditors usually include a diverse set of public and private lenders and stakeholders, including

<sup>1</sup> See United Nations *World Economic and Social Survey 2010: Re-tooling Global Development* and MDG Gap Task Force Report 2010: *The Global Partnership for Development at a Critical Juncture* a more detailed discussion of the issues.

members of the Paris Club, multilaterals, domestic and international banks, domestic and international bondholders, and domestic stakeholders to which the government owes arrears. Unlike corporate bankruptcies where priority is generally relatively clear, the order in which most classes of creditors (other than the multilaterals) get repaid in sovereign debt is not delineated. Countries tend to choose which creditor groups to default on and which to repay on an ad hoc basis.

On the lending side, one question that should be addressed is why creditors often continue to lending afresh to countries, even as the countries' debt profiles rapidly deteriorate, as was the case in many emerging market countries prior to their defaults, and has been the case in Southern Europe more recently. In particular, there is evidence that periods of excessive lending (followed by sudden stops) is greater in sovereign debt than in other financial markets. This type of creditor behaviour is not, however, completely myopic. It can be caused by poor information from the sovereign, though this has improved dramatically over the past few decades, the recent scandals notwithstanding. In addition, to the extent that creditors expect the IMF, or the EU, to bail-out sovereigns in debt distress, creditors *should* be willing to lend more than fundamentals would suggest. Similarly, the belief that a country in distress will restructure its debt in a market friendly manner, with little loss to the creditor, would lead to excess lending. In other words, the framework for sovereign debt restructuring affects incentives of creditors (as well as debtors) prior to default, and the current system appears to create moral hazard, which contributes to excessively high indebtedness in some countries.

## Debt relief for low-income countries

Prior to the Heavily Indebted Poor Countries (HIPC) Initiative, many low income countries underwent a series of sequential debt restructurings with the Paris Club, which generally extended the maturity of debt payments, but provided little debt relief. The HIPC Initiative was launched in 1996, partially in response to these serial restructurings. The HIPC accepted the idea of a 'fresh start' and placed poverty reduction strategies at the center of development cooperation for the first time. Yet the HIPC did not sufficiently lower the debt burden of many of the selected countries. It was not until nearly ten years later when the HIPC was supplemented by the Multilateral Debt Relief Initiative (MDRI), partially due to pressure from civil society groups, that countries were granted full debt relief. However, these programs only apply to a limited number of countries. In addition, they are limited to

Paris Club and multilateral lenders, and do not necessarily cover donors and lenders outside of the Paris Club, who are becoming significant players. Most importantly, they were one-time write-downs, and do not address the issue of how to respond to unsustainable debt burdens in the future.

## Toward a New Framework for Sovereign Debt Restructuring

Countries have run up unsustainable debt burdens in the past, and this can easily happen again in the future. A new framework for sovereign debt restructuring is critical to developing a stable international financial system that promotes economic development enabling countries to achieve the MDGs.

The goals of a new framework should be to reach a timely, fair, efficient, and comprehensive restructuring that respects creditors' rights while providing debtors room to grow. There are two key governance challenges. First, the process should mediate effectively and fairly between debtors and creditors. This means that the adjudication must be lodged with an independent body. Second, the process should be enforceable on all creditors in all jurisdictions, which means that all Nations must commit to enforcing debt resolution decisions, which would likely require amendments in domestic contract laws.

There are several possible structures that could be developed. An international debt court, overseen by a representative board of directors, could be established as the resolution entity. As an alternative and complementary measure, an International Mediation Forum could be formed, which could facilitate the creation of norms for sovereign debt restructurings while the international court is being established. This mechanism could function through a system of independent panels of experts, similar to those used under the dispute settlement mechanism of the World Trade Organization, and could serve as a voluntary mechanism in the 'shadow' of the court. ■

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