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Sovereign debt, the International Financial Architecture and Power Dynamics

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Finance for development: main tenets

1. Stable, long-term
    - e.g. returns to education require around 30 years to be repaid

2. Sufficiently low rates

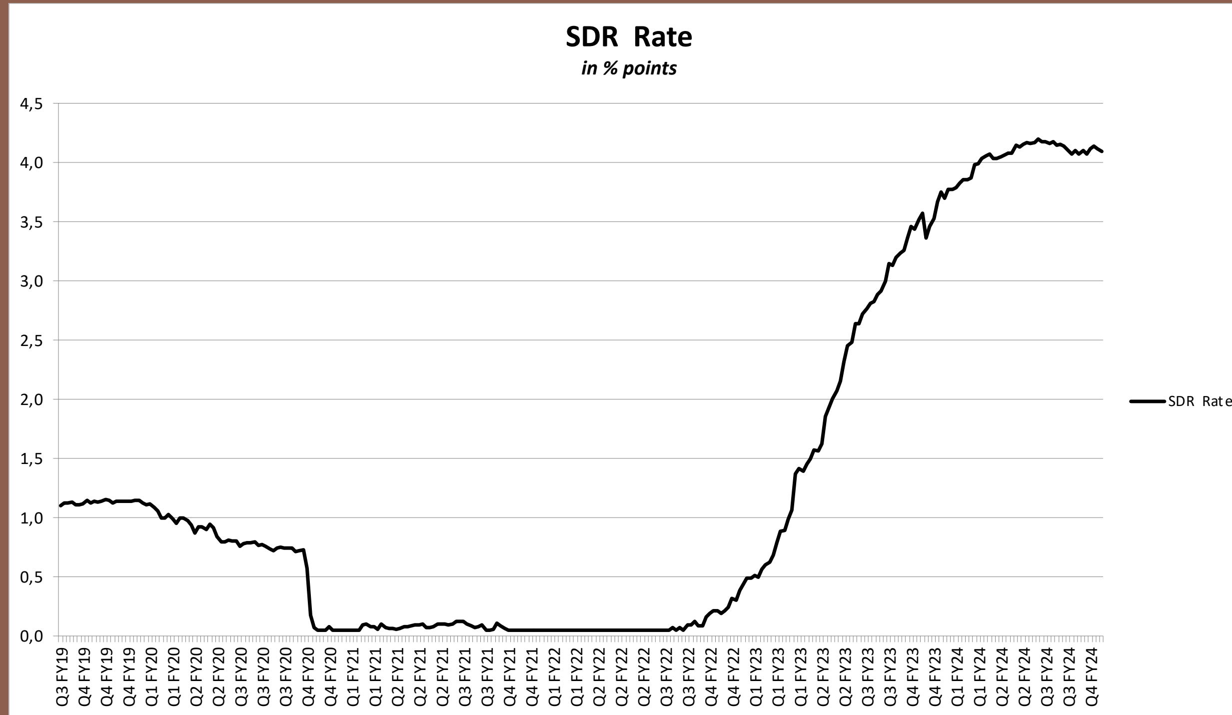
(This discussion would not take place if there were perfect capital markets.)

An asymmetric global financial system

- Private capital flows are procyclical for developing nations and countercyclical for advanced nations
    - Latin American debt crisis of the 1980s and today's debt crises in the South are examples of this asymmetry

- Official capital flows do not outweigh that asymmetry
    - Certain policies can even exarcebate it (e.g. lending cost tied to SDR rate or IMF surcharges and investment model)

The SDR rate is determined by monetary policy in AEs



The anatomy of the procyclicality of capital flows for developing nations

- Increase in global liquidity as consequence of monetary policy in advanced economies (AEs)
  - Low rates in AEs, search for yields
- Capital flows to “riskier” economies
  - Short-term and expensive
- If a shock leads to contractionary monetary policy in AEs, flows revert
  - Flight to quality
- Multiple externalities (exchange rate depreciations, etc.)
  - ”incomplete markets”: impossible to insure from those shocks
- Development falters

The anatomy of the procyclicality of capital flows for developing nations: the debtor side

- Low savings, thin capital markets

- Credit-constrained, high “shadow price” of financing

- Also: political economy considerations:
  - Discount factor for government is likely higher than for the society

- Credit/debt decisions thus mostly determined by creditors’ willingness to provide financing

- When flows revert, same structure of incentives applies
  - Leading to *too little and too late* debt restructurings and “high” short-term value for both governments and private creditors of bailouts by IFIs
  - With high short-medium term cost

A series of events with global debt distress consequences

The external debt of poorer countries has surged since 2000

External public debt of low and lower-middle income countries, by creditor ($bn)

Multilateral institutions | Private | Paris Club | China | Other non-Paris Club

1400
1200
1000
800
600
400
200
0

2000 2005 2010 2015 2020

Source: World Bank

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The proportion of poor countries at risk of debt distress has soared

Risk of debt distress (% of DSSI countries with DSA*)

Low | Moderate | High | In debt distress

100
80
60
40
20
0

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022

* G20 Debt Service Suspension Initiative countries with Debt Sustainability Analyses
Source: IMF
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Net transfers on LT External Debt to LLMICs

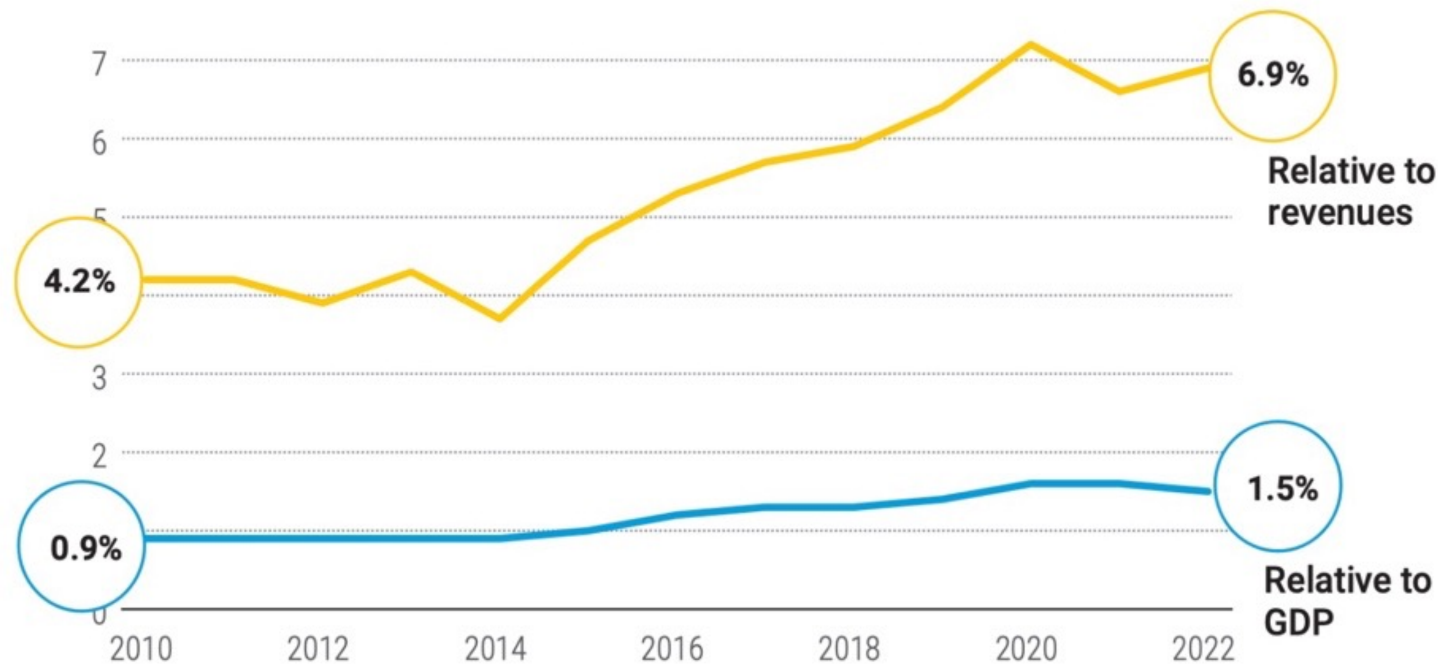
(Diwan-Guzman-Kessler-Songwe-Stiglitz 2024)

	Total NT TL debt	IFIs	Bilateral creditors	China loans	Private lenders
2019	84.4	28.9	1.7	4.6	54.3
2020	55.2	68.3	8.6	0.9	3.0
2021	45.4	27.3	6.4	3.5	11.0
2022	-15.7	32.2	9.8	-6.1	-51.2

Total negative net transfers (NT), with positive NT from International Financial Institutions (IFIs) and large negative NT to private creditors

Figure 8: Developing countries use more resources to pay interest on their public debt

Net interest payments of developing countries as a share of GDP and government revenues



Sources: UN Global Crisis Response Group calculations, on IMF World Economic Outlook (April 2023).
Note: Median shares across developing countries.

The macroeconomics of sovereign debt distress

- Current situation applies to countries with thin capital markets and weak currencies

- Three main options in those countries to improve current account if there is no external debt operation:
    - Contract imports → recession
    - Expand exports → it does not happen in the short run
    - Deplete reserves → countries in debt crisis generally have no reserves

Addressing debt sustainability problems under the current global financial architecture

A “no-system” for sovereign debt crises resolution

- Characterized by bargaining between a distressed debtor and its creditors based on decentralized market-based instruments (mostly issued under NY or English law)
- Outcomes are deficient: *Too Little, Too Late*
  - From 1970 - 2014, more than half of the restructurings with private creditors were followed by another restructuring with private creditors or default within 5 years (Guzman, Ocampo, and Stiglitz 2016, *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises*)

Evolving inter-creditor problems

- Changing weights and roles of private bondholders, Paris club creditors, and non-Paris club creditors (mainly China)

Role of IMF

Restructuring of sovereign debts with the private sector featured by pervasive asymmetries between the sovereign debtors and creditors

POWER

- Financial resources/Networks/*Lobbying*

INFORMATION

- SCDS, Lack of Transparency *on composition of bondholders' universe*

TIME HORIZONS

- Political economy considerations

MORAL HAZARD

- Incentives for holdout behavior
- Litigation by vulture funds
- Positive: enhanced CACs help

Evolving inter-creditor coordination problems

ZAMBIA

GHANA

ETHIOPIA

CHAD

Unsurpisingly, a failure

Domestic currency v. foreign currency debt

- Development of local currency debt markets was generally not accompanied by adoption of capital account regulations

- Leading to the same problems of instability associated with financing in foreign currency

- The current situation: flawed approach for treatment of domestic v. foreign currency debt in recent restructurings (e.g. Sri Lanka)
  - ➢ Using same principles for the restructuring of domestic and foreign currency debt undermines the prospects for financing for development

The role of capital account regulations for the stability and cost of financing

- The case for capital account regulations in an environment of imperfect capital markets is well established

- The goal is to disincentivize carry-trade flows that create *excessive* instability of the exchange rate and of the financing conditions in domestic currency

- But to encourage more stable flows (FDI)
  - And enable the development of a domestic capital market for local savings and the management of foreign liquidity in the domestic economy

What can be done to improve matters?
Proposal I: Statury approach for sovereign debt crisis resolution

- **Missing piece from post WWII multilateral architecture**

→ 2014: UNGA Resolution 68/304: “Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes”

→ 2015: UNGA Resolution 69/319: “Basic Principles on Sovereign Debt Restructuring”

  - **Guzman and Stiglitz 2016, A Soft Law Mechanism for Sovereign Debt Restructuring Based on the UN Principles**

What can be done to improve matters?
Proposal II: Better contracts

- In recent restructurings, design of contingent bonds to maximize creditors' recovery (e.g. Sri Lanka, Suriname)

→ No or very little protection for debtor in the downside, large payments in the upside

- Enhanced CACs help to address inter-private creditors coordination problems but do not suffice
  - Argentina's 2020 debt restructuring was the first test

Enhanced CACs help to address inter-private creditors coordination problems: *Argentina 2020*

8 series of bonds 2005 / 2010	17 series of bonds of 2016
Third Generation CACs 75% series-by-series or two-limb 85% of the capital of all affected bond series 2/3 of the capital of each of the bond series	**Fourth Generation CACs** 75% series-by-series or two-limb 2/3 of each affected series 50% of each series or Single-limb 75% of total, if uniformly applicable

Argentina used solely the two-limb aggregation method and chose not to use the single-limb aggregation mechanism for the bond series of 2016

Enhanced CACs help to address inter-private creditors coordination problems. *Argentina 2020*

Results of the restructuring process (under foreign law)

- **Eligible amount: USD 66,1 million**
  - ➔ *2005 Trust Indenture*: USD 24,258 mill. (37%)
  - ➔ *2016 Trust Indenture*: USD 41,927 mill. (63%)

- **Amount restructured: USD 65,5 million**
- **% exchanged**
  - 94.55% consent
  - 99.01% exchanged after CACs activation
    - *98.94% under 2005 indenture*
    - *100% under 2016 indenture*

- **Average coupon : 3% (vs. 7%)**
- **Average principal reduction: 1.9% (vs. 7%)**
- **Average maturity : 11.4 years (vs. 13.2 years)**

What can be done to improve matters? Proposal III: widespread adoption of Capital Account Regulations

- **Regulations on inflows** (Guzman et al. 2024)
- **More effectiveness if there are changes in institutional views of international organizations**
  - ➔ It goes against the dominant power dynamics
  - ➔ The way domestic currency debts are treated in current debt crises will have major consequences for the sovereign financing landscape

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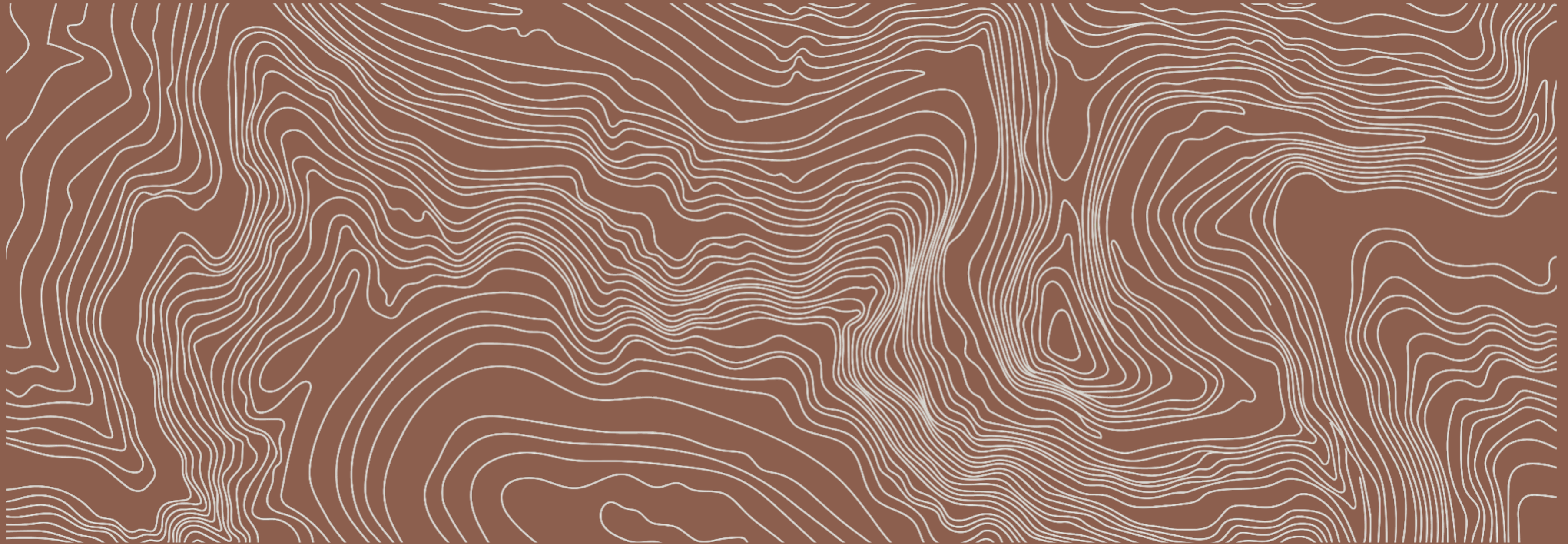

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