Lecture Note for Day 3 (April 30, 2014)

Course	Sovereign Debt: Lessons from History and Future Implications II
Course No.	5123432 Summer 2014
Instructor	Toshiro Nishizawa
Subject	Sovereign debt, default, and debt restructuring

This lecture note is an updated version of the one used on October 30, 2013 for Sovereign Defaults: Lessons from History and Future Implications (Course No. 5123430 Winter 2013) prepared based mainly on: Sturzenegger, Federico, and Jeromin Zettelmeyer. 2006. *Debt Defaults and Lessons from a Decade of Crises*. Cambridge, MA: The MIT Press: 3-29.

1. Sovereign debt

Question: *What is "sovereign debt"?*

1.1. An explicit or literal meaning of the term "sovereign debt" is as defined in language dictionaries. For example, Oxford Dictionaries Online has such an entry as "the amount of money that a country's government has borrowed, typically issued as bonds denominated in a reserve currency". But this kind of definition, simply saying "sovereign debt" is a government debt, does not tell anything about its unique characteristics.
cf. http://www.oxforddictionaries.com/definition/american_english/sovereign-debt

1.2. In business dictionaries, we could find a somewhat more detailed definition such as "Under the doctrine of sovereign immunity, the repayment of sovereign debt cannot be forced by the creditors and it is thus subject to compulsory rescheduling, interest rate reduction, or even repudiation. The only protection available to the creditors is threat of the loss of credibility and lowering of the international standing (the sovereign debt rating) of a country, which may make it much more difficult to borrow in the future."
cf. http://www.businessdictionary.com/definition/sovereign-debt.html

1.3. In order to understand the unique characteristics of "sovereign debt," we need to know what "sovereignty" or "sovereign immunity" means.

"sovereignty": "The supreme, absolute, and uncontrollable power by which any independent state is governed; supreme political authority; the supreme will; paramount control of the constitution and frame of government and its administration; the self-sufficient source of political power, from which all specific political powers are derived; the international independence of a state, combined with the right and power of regulating its internal affairs without foreign dictation; also a political society, or state, which is sovereign and independent."; and "The power to do everything in a state without accountability,—to make laws, to execute and to apply them, to impose and collect taxes and levy contributions, to make war or peace, to form treaties of alliance or of commerce with foreign nations, and the like." (Black's Law Dictionary, Abridged Sixth Edition)

"sovereign immunity": "A judicial doctrine which precludes bringing suit against the government without its consent. Founded on the ancient principle that 'the King can do no wrong,' it bars holding the government or its subdivisions liable for the torts of its officers or agents unless such immunity is expressly waived by statute or by necessary inference from legislative enactment." (Black's Law Dictionary, Abridged Sixth Edition)

2. Sovereign default

Question: *What is "sovereign default"?*

2.1. In this course, as described in the syllabus, we define a sovereign default as "the *failure or refusal* of a government to meet payments on its debt obligations to either domestic or external creditors, or to both."

2.2. Technically speaking, "From a legal point of view, a default event is an episode in which a scheduled debt service is not paid beyond a grace period specified in the debt contract." (Hatchondo, Martinez, and Sapriza 2011, page 137) We broaden this definition in a legal sense by including "an episode in which the sovereign makes a restructuring offer that contains terms less favorable* than the original debt."

*: Less favorable for creditors, not for debtors.

2.3. What is the difference between corporate and sovereign defaults (bankruptcies)?

"…, countries do not usually go out of business."

"…, country default is often the result of a complex cost-benefit calculus involving political and social considerations, not just economic and financial ones."

There is no "super-national legal framework for enforcing debt contracts across borders," meaning that the lender's options for direct enforcement of its claims are limited.

3. The nature of the default and debt restructuring episodes in the last two hundred years (1820-2003)

3.1. Most fiscal crises of European antiquity were resolved thought inflations or devaluations rather than debt restructurings. Defaults dealt with debt restructurings became common in the modern era.

3.2. Numbers and geographical incidence of debt crises, defaults, and debt restructurings exploded in the nineteenth century as the by-product of increasing cross-border debt flows, newly independent governments, and the development of modern financial markets.

Question: *Why did debt restructuring exercise become more common only in the modern era?*

4. Defaults bunching in temporal and regional clusters corresponding to boom-bust cycles

4.1. In the early 1820s: newly independent Latin American countries, some European countries

4.2. In the 1830s: United States, Spain, Portugal

4.3. From the 1860s to the mid-1870s: Latin America, United States, European countries

4.4. In the mid- to late 1880s: United States, Australia, Latin America

4.5. In the decade prior to World War I: Canada, Australia, South Africa, Russia, Ottoman Empire, Balkan countries, some Latin American countries

4.6. In the 1920s: Germany, Japan, Australia, Canada, Argentina, Brazil, Cuba

4.7. In the 1970s: Latin America, Spain, Yugoslavia, Romania, Poland, Turkey, Egypt, Indonesia, some African countries

4.8. In the 1990s: Latin America, emerging Asia, former Communist countries in Eastern Europe

5. The origins of lending booms

5.1. Political change creating a demand for capital or opening new investment opportunities

e.g. "…; flows to Africa in the 1960s and 1970s were triggered by African decolonization and independence; …."

"…; and a portion of the 1990s boom was triggered by the collapse of Communism."

The East Asian Miracle in the early 1990s

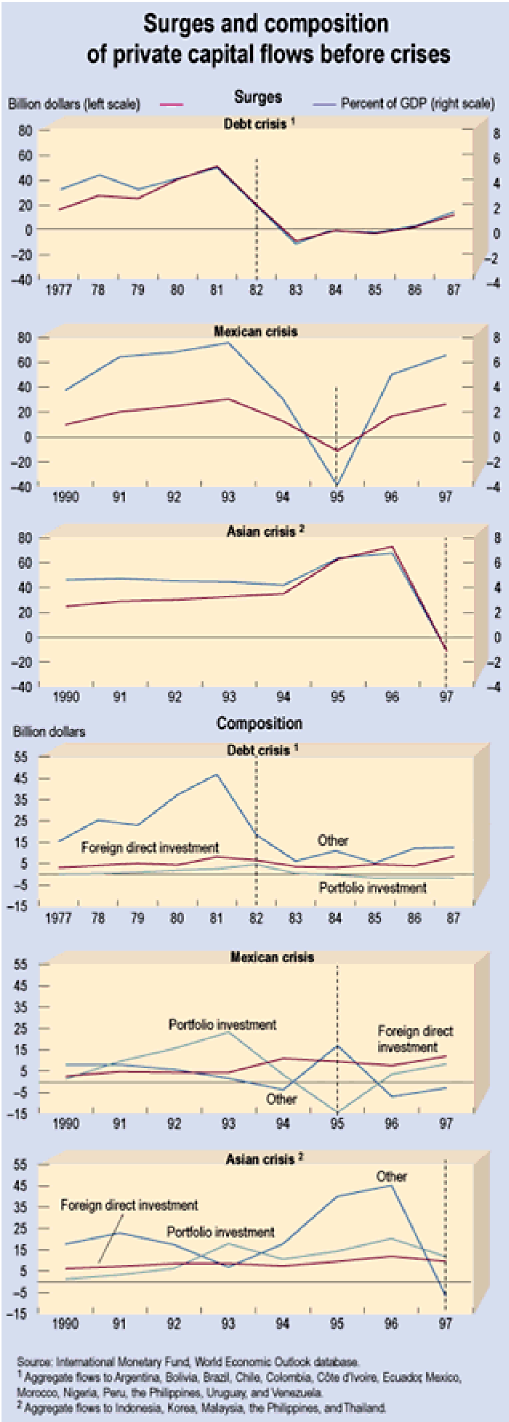
5.2. Economic changes resulting from technical progress, reform or stabilization policies, improvements in the terms of trade

cf. "terms of trade": "The terms of trade is one of the most important relative prices in economics. The ratio of the prices of a country's exports to the prices of its imports defines the net barter terms of trade, which measures the number of units of imports that can be exchanged for a unit of exports. Changes in the terms of trade have an especially strong impact on the macroeconomic performance and incomes of commodity-exporting developing countries." (Cashin, Paul, and Catherine Patillo, *The Duration of Terms of Trade Shocks in Sub-Saharan Africa*. Finance & Development, June 2000, Volume 37, Number 2)

e.g. "The boom of the 1990s was in some part a reaction to economic reforms in debtor countries that appeared to usher a new era of growth."

5.3. Conditions in creditor countries such as cycles of economic growth and private savings, changes in the financial systems and lender liquidity, and so on

e.g. "…, the 1970s boom in bank lending to developing countries originated in the 1960s, when U.S. banks lost a portion of their domestic business to corporate debt markets and began to look for lending alternatives abroad. This incipient boom received a boost after the oil price shocks of 1973-1974 led to high oil earnings in search of investments."



Source: Mathieson, Donald J., Anthony Richards, and Sunil Sharma. 1998. *Financial Crises in Emerging Markets*. Finance & Development. IMF: Washington, DC. December 1998, Volume 35, Number 4. Accessed April 29, 2014. http://www.imf.org/external/pubs/ft/fandd/1998/12/mathies.htm

6. Factors to trigger busts

6.1. a deterioration of the terms of trade of debtor countries

6.2. a recession in the core countries that were the providers of capital

6.3. a rise in international borrowing costs driven by events in creditor countries, such as tighter monetary policy

6.4. a crisis in a major debtor country, transmitted internationally through financial and trade linkages

Question: *What other factors do you think of as a trigger of bust?*

7. Characteristics of the latest default cycle (1998-2004)

In the 1990s, a higher share of lending to emerging markets, particularly in the Asian countries, was absorbed directly by the private sector. Therefore, the end of the lending boom in 1997 resulted in a private debt crisis involving thousands of corporate defaults, followed in many cases by the banking sector crisis.

cf. "…, the Indonesian economy during the period 1989 through 1996 grew at an average annual real rate of 8 per cent, led by strong investment growth. Macroeconomic fundamentals also appeared to be strong, since inflation at 10 per cent a year, though a little higher than the other East Asian economies, was still low by developing country standards. The overall fiscal balance was in surplus after 1992, while public debt as a share of GDP had fallen as the government used privatization proceeds to repay a large amount of foreign debt."

"…, one could in hindsight identify some worrisome early warning indicators, particularly the rapid increase in foreign borrowing by the private sector since the early 1990s." (Wie, Thee Kian. 2012. *Indonesia's Economy since Independence*. Singapore: Institute of Southeast Asian Studies. page 117.)

Question: *Although the lending boom to Indonesia in the 1990s resulted in a private debt crisis, why did the Indonesian government resort to rescheduling of debt owed to its official bilateral creditors under the Paris Club and its commercial creditors under the London Club?*

8. Creditor-debtor settlement—creditor coordination

8.1. "Between the 1820s and 1870, negotiations between debtors and creditors proceeded through ad hoc creditor committees."

- ✓ inefficient at least from a creditor perspective (on average, fourteen years until settlements)

Question: *Why were creditor-debtor negotiations through ad hoc creditor committee inefficient?*

8.2. With the establishment of the British Corporation of Foreign Bondholders (CFB) in 1868, the CFB and, as time passed CFB-type organizations in other countries as well, began to play a central role in creditor coordination and creditor-debtor settlement until the 1950s.

- ✓ effective control over the sovereign debtor's access to the London market for new borrowing
- ✓ mostly successful settlements (on average, six years until settlements)

"Although the agreement was not legally binding on individual bondholders, 'holdouts' generally did not pose a problem, in part, because the chances of successful legal action against sovereigns were much lower than they are today."

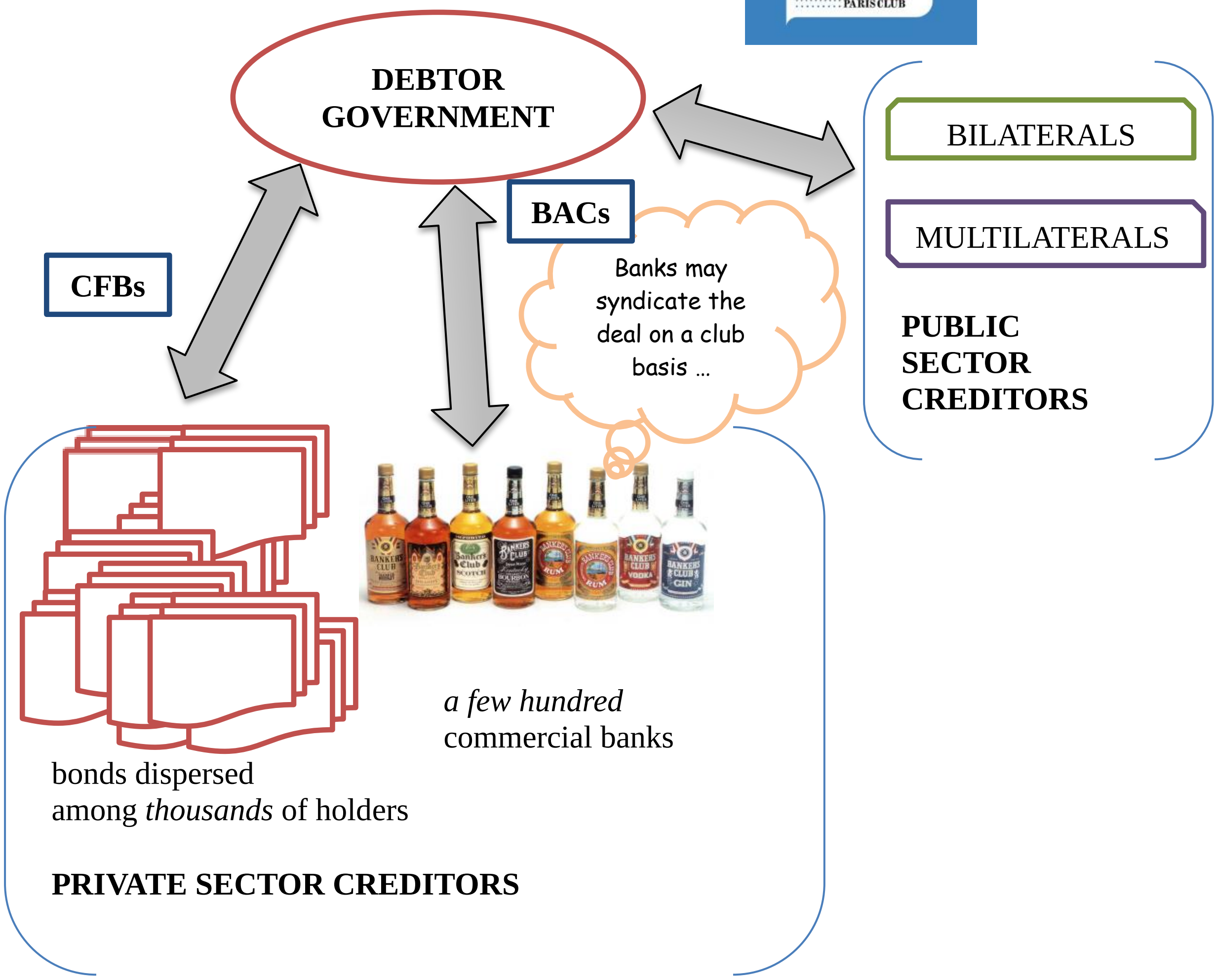
cf. "holdout": A holdout problem occurs when a bond issuer in default or near default launches an exchange offer in an attempt to restructure existing debt. Such exchange offers typically require the consent of holders of some minimum portion of the total outstanding debt (*e.g.*, 90%). If non-consenting bondholders (holdout creditors) retain their legal right to demand repayment of original bonds at par (the full face value), the restructuring process may be disrupted.

8.3. By the 1970s, the structure of international private capital flows had changed from bonds to loans, where syndicates became a typical form of bank lending. When several developing country debtors began to experience debt servicing difficulties in the late 1970s, the "Bank Advisory Committee" (BAC) process became a coordinated negotiating procedure for the restructuring of commercial bank debt (the so-called "London Club").

- ✓ A restructuring deal is negotiated initially in the form of a "term sheet" and is followed by a documentation package which becomes legally binding for each individual creditor only after its signature.
- ✓ very efficient process (often settled in months in the early 1980s and, with the Brady deals, generally one or two years in the late 1980s and early 1990s)

"London Club"! No, this is not the emblem of "London Club", but of "The City of London Club," which was established in 1832 and is the oldest of the gentlemen's clubs based in the City of London.

cf. Paris Club
Website: http://www.clubdeparis.org/en/



Question: *What are the major similarities and differences between the CFBs and BACs?*

8.4. Most debt crises and restructurings in recent years since the late 1990s focused on sovereign bonds held by a heterogeneous group of creditors, mostly nonbanks (except for the Asian Financial Crisis)

- ✓ the lack of representation of bondholders by a formal committee such as the CFB in the nineteenth and early twentieth centuries
- ✓ despite the lack of formal creditor coordination, the 1998-2005 debt restructurings undertaken relatively quickly (within months, except for Argentina's case)
- ✓ "take-it-or-leave-it" offers to exchange the existing bonds for new ones with a reduced debt burden

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References

Cashin, Paul, and Catherine Patillo. 2010. "The Duration of Terms of Trade Shocks in Sub-Saharan Africa." *Finance & Development*. IMF: Washington, DC. June 2000, Volume 37, Number 2: 26-29.

Hatchondo, Juan Carlos, Leonardo Martinez, and Horacio Sapriza. 2011. "Understanding Sovereign Default." In *Sovereign Debt: From Safety to Default*, edited by Robert W. Kolb, 137-147. Hobeken, NJ: John Wiley&Sons.

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Proposed Issues for Discussion in this Course and for Student Research

I would like to propose that the following issues be covered in this course during the rest of the semester. I would also like to suggest that the following issues be considered as your research topic for final presentation and report. We will discuss on Day 3 more specifically how to incorporate these issues in our course program.

1. **Analysis of policy options to avoid budget deficits and to manage external debt (debt sustainability analysis)**

   cf. Program of Seminars: Restoring Public Debt Sustainability in a High-Risk Environment (October 10, 2010)
   http://www.imf.org/external/mmedia/view.aspx?vid=1890297041001

2. **Underlying factors causing sovereign default and the extent of its effect on the country and other sovereign states (European sovereign debt crisis)**

   cf. Europe on the Mend? (longer version) (September 25, 2013)
   http://www.imf.org/external/mmedia/view.aspx?vid=2693791836001

   European Recovery in Longer-Term Perspective (October 9, 2013)
   http://www.iie.com/events/event_detail.cfm?EventID=299

3. **Treatment of sovereign default as a "game" for cost sharing among a debtor government, private creditors, and creditor governments—legal and economic framework to deal with sovereign default and debt restructuring (Argentina, Greece, SDRM)**

   cf. Sovereign Debt Restructuring: Lessons from Recent Experience (October 12, 2013)
   http://www.imf.org/external/mmedia/view.aspx?vid=2740132574001

   The Yin and Yang of the European Sovereign Debt Crisis (October 17, 2013)
   http://www.piie.com/events/event_detail.cfm?EventID=303

4. **Holdout creditors (Argentina)**

   cf. Opinion: When Countries Go Bankrupt (December 11, 2012)
   http://live.wsj.com/video/opinion-when-countries-go-bankrupt/6DA037D8-EAF0-4F22-8AD8-0FA46E7C4EB9.html#!6DA037D8-EAF0-4F22-8AD8-0FA46E7C4EB9

   Argentina v. Holdout Creditors: Applying the Rule of Law to Resolve Debt Default (December 11, 2013)
   http://www.netcastia.com/Cato-Institute-Event-Videos-Full/Argentina-v-Holdout-Creditors-Applying-the-Rule-of-Law-to-Resolve-Debt-Default

("In 2001, Argentina defaulted on $81 billion of debt — the largest sovereign default in history. While years later most of its creditors settled to swap their old bonds with heavily discounted new bonds, a group of holdout creditors challenged Argentina in the courts. In October 2012, the U.S. Court of Appeals for the Second Circuit sided with plaintiffs to rule that Argentina must treat all its creditors equally and pay owners of defaulted bonds that were issued under New York law. As the long standoff nears judicial resolution, a distinguished panel of experts will discuss the significant implications of this case for the protection of creditor rights, future debt restructuring processes, and emerging markets.")

Argentina asks top US Court to stop 'catastrophe' (February 18, 2014)
http://newsok.com/argentina-asks-top-us-court-to-stop-catastrophe/article/feed/652895

US justices signal limited win for bondholders against Argentina (April 21, 2014)
http://www.cnbc.com/id/101598881

Argentine Debt Restructuring
http://en.wikipedia.org/wiki/Argentine_debt_restructuring

5. Populism and sovereign debt (the case of sovereign liabilities motivated by politics and giving rise to economic risk)

cf. Rice pledging: the human toll Farmers resort to loan sharks, pawnshops (February 16, 2014)
http://www.bangkokpost.com/business/news/395370/rice-pledging-the-human-toll

How to Live with Populism (September 1, 2013)
http://tdri.or.th/en/multimedia/tdri-channel-how-to-live-with-populism-with-veerathai-santiprabhob-2/

6. How could borrowing by a present government (administration) be justified as the payment obligations of existing tax payers and/or future generations? (Odious debt)

cf. Odious Debt (June 2002)
http://www.imf.org/external/pubs/ft/fandd/2002/06/kremer.htm

The Legal Basis to Reject Odious Debt (October 25, 2011)
http://www.youtube.com/watch?v=Qp0o-VJiCAQ

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