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A GLOBAL SOVEREIGN DEBT RESTRUCTURING REGIME

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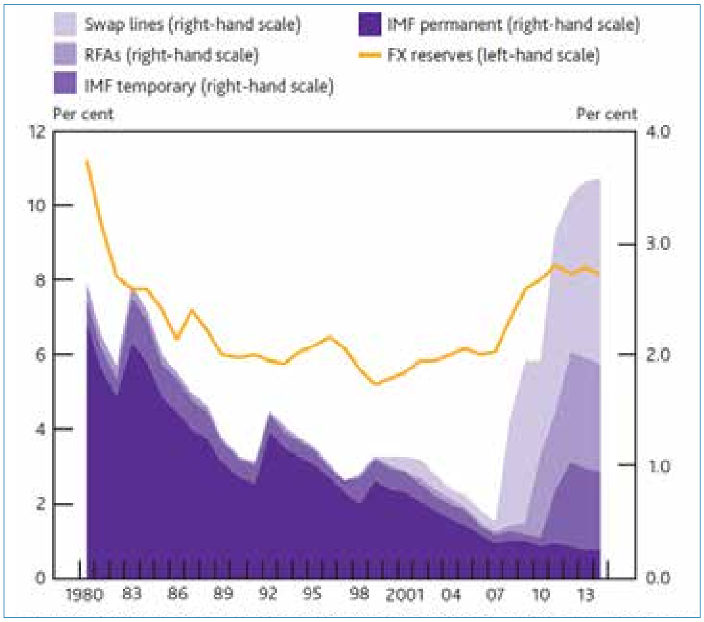
Key Points

- The Group of Twenty (G20) has expanded the global financial safety net, but failed to align access criteria and sovereign debt restructuring requirements across its various players and layers — for example, the International Monetary Fund (IMF); regional financing arrangements (RFAs), such as the European Stability Mechanism (ESM) in Europe, and the Chaing Mai Initiative Multilateralization (CMIM) in Asia; the BRICS (Brazil, Russia, India, China and South Africa) Contingent Reserve Arrangement (CRA); and more than 40 bilateral swap lines.
- International crisis lending is now fragmented and lacks a consistent and credible regime for sovereign debt restructuring. This may result in weakened incentives for sound policies, overborrowing at the front end, and procrastination and restructuring "too little, too late" at the back end.
- The IMF has gradually hardened access criteria and debt restructuring requirements for exceptional access lending, while the other arrangements mostly do not have clear frameworks or remain untested. This may set up an inherent conflict between international crisis lenders, with the IMF playing tough and regional lenders ending up offering (too much) concessional financing.
- The inconsistencies can be eliminated by either fully aligning the various decentralized parts with the centre (the IMF), thus reunifying the global safety net, or by implementing decentralized policies across all players with binding access policies and restructuring criteria that are at least as strict as those of the IMF.
- In the case of the euro zone, there is the additional option to "do it yourself" as a step toward completing the monetary union: this would involve dismantling the "Troika," implementing hard restructuring requirements for ESM access while simultaneously clearing the debt overhang. The German G20 presidency is uniquely positioned to address all of these issues.

Introduction: A Missing Building Block in the International Financial Architecture

Eight years ago, the G20 set out to overhaul the international financial architecture. Today, the amount of crisis lending available for sovereigns (the global financial safety net) has been greatly expanded, increasing about sixfold between 2007 and 2014. By far the largest part of growth has been in RFAs, bilateral swap arrangements and self-insurance in the form of international reserves (see Figure 1). As a result, the global safety net is now highly fragmented. Multiple players and layers imply that access is uneven across countries and regions, predictability and costs of different arrangements vary significantly and, most importantly, consistent incentives for ensuring sound policies are not in place (IMF 2016a).

Figure 1: Size of the Global Safety Net as Percentage of External Liabilities 1980–2014



Source: Denbee, Jung and Paternò (2016).

Notes: With the ratification of the fourteenth quota review, the IMF permanent resources will double and the temporary ones will fall by the same amount.

Such design failures can be explained: a good part of the expansion of the global safety net was initially decided in emergency mode. Exceptional cross-border liquidity provision by central banks and the various European regional borrowing arrangements were all born of necessity and pragmatism rather than from a global design. Nevertheless, most of the new arrangements have become permanent, so the design failures and mismatches need to be addressed if the new international financial architecture is to be more robust than the old one.

The fragmented system fails to encourage sound policies because access criteria, conditionality and sovereign debt restructuring requirements vary across arrangements. This brief focuses on the disincentives created by an inconsistent sovereign debt restructuring regime. For instance, RFAs may undermine restructuring requirements at the centre, creating disincentives for prudent borrowing. Access to IMF resources is predicated on a positive assessment of debt sustainability, but this is not consistently the case for other parts of the safety net. Hence, some countries with unsustainable debt dynamics may be able to receive funding from soft sources. Different debt restructuring requirements across arrangements will likely result in procrastination: restructuring too little, too late and at too high a cost both for the debtor country and possibly for the RFA. The IMF has recently tightened its debt sustainability analysis framework, abolished the systemic exemption and opened the door for substitution through other official lending (IMF 2013a; 2013b; 2016b). Most RFAs are bound to be softer than the IMF and this may be setting up a permanent line of conflict between the two. Taken together, this suggests that the global framework for sovereign debt restructuring remains incomplete and distorts incentives.

Preventive Incentive Effects of a Sovereign Debt Restructuring Regime

Much of the debate on a Sovereign Debt Restructuring Mechanism has focused on the *ex post* issues, namely how to minimize the costs of debt crises once they occur. The key concern is to limit the potential for holdout creditors to block or frustrate a comprehensive sovereign debt restructuring. These issues are being addressed through a contractual approach by gradually modifying new debt contracts with clauses (collective action clauses and *pari passu*) in order to facilitate orderly restructuring.

Arguably an even more important function of a credible sovereign debt restructuring regime lies in aligning *ex ante* incentives toward prudent and sound policies. A predictable limit on overborrowing will help harness market forces and discipline both debtors and private creditors. Thus, an effective sovereign debt restructuring regime acts preventively by limiting overborrowing and procrastination.

The current framework for sovereign debt restructuring is enshrined in the access criteria for international crisis lending: the criteria determine if and how much debt restructuring should take place to unlock crisis lending. There is hardly any disagreement on the basic principle guiding international crisis lending, namely that it should go only to sovereigns that are conditionally solvent, while in all other cases a debt restructuring is needed first. It is more difficult to implement this principle in practice. First, it is because the dividing line between liquidity and solvency is never crystal clear. Sovereign solvency depends not only on economic variables, but also on political and institutional factors — all may change all the time. Thus, the division between liquidity and solvency is a fuzzy gray zone rather than a sharp line. But the shape of the gray zone matters because of the second issue: incentives to misdiagnose a solvency crisis can be strong. Any debt restructuring will carry some immediate costs — for example, political cost to the incumbent government, concerns for financial stability and contagion — which will reinforce incentives to wait and gamble for resurrection. The cost of misdiagnosing and restructuring too little, too late will be great, but this cost falls into the future. This is why international crisis lenders need a strong framework that enforces the principle and limits time inconsistency (also called kicking the can down the road).

Gradual Hardening of Debt Restructuring Requirements at the IMF

The IMF's struggles with the disincentive effects of debt restructuring requirements are reflected in its evolving lending policies and gradual hardening of requirements over the past few years. In particular, the IMF has tightened the lending framework (for exceptional access cases) by defining the boundaries of the gray zone and by closing an important loophole. The gray zone is now identified by a tractable model of debt sustainability analysis, which narrows the scope for interpretation and discretion (IMF 2013a; 2013b). Risks of debt distress are based on an estimated model and numeric thresholds that vary by country groups.

Table 1 shows a selection of indicators and thresholds that enter the debt sustainability analysis at the IMF. For instance, the IMF will regard a country at risk of debt distress if the current or stressed face value of debt-to-GDP exceeds 85 percent for an advanced economy, or 70 percent for an emerging market. For low-income countries, the thresholds apply for the present value of debt-to-GDP and depend on a policy rating; countries with higher policy ratings are considered to be more resilient and have higher thresholds of indebtedness. Note there are many indicators and variables that enter the analysis and the stress scenarios, which still leave room for interpretation and disagreement on the size of the gray zone. Nevertheless, this system of indicators and thresholds has greatly increased the transparency and tractability of the main gatekeeper for access to IMF crisis lending. By the same token, it has clarified and hardened the debt restructuring requirements for countries that have access to the IMF only.

The second reform at the IMF was to close the loophole that was opened in the wake of the first Greek program, the systemic exemption. This allowed access to IMF lending without a restructuring requirement, even in cases of doubtful debt dynamics, if there were wider systemic concerns. The exemption was invoked 34 times and remained highly controversial. It was finally abolished at the beginning of 2016 (IMF 2016b). Again, this has reduced the amount of discretion in IMF access and in the debt restructuring regime.

At the same time, another back door was opened in the IMF's exceptional access policy (IMF 2016c). Access can be granted even in cases where debt is considered "sustainable but not with a high probability" if financing is provided from sources other than the Fund, and if this improves sustainability and safeguards resources of the Fund (ibid.). This may be interpreted as an invitation for other official lenders, in particular RFAs, to jump into the gap.

Table 1: Thresholds for Risk of Debt Distress under Different Models for Debt Sustainability Analysis (Selection of Indicators)

	IMF		
	Market-access countries		
	Advanced economies	Emerging markets	Low-income countries
Debt/GDP	85%	70%	*Policy Rating* Weak 38% Medium 56% Strong 74%
Gross financing needs	20%	15%	

Source: Schumacher and Weder di Mauro (2016).

Notes: Gross financing needs represent the sum of debt payments, the primary balance, and individual payments or revenues (such as privatizations) in any given year. The IMF/World Bank low-income country framework is conditioned on the quality of the country's policies and institutions.

Unclear Debt Restructuring Requirements of Other International Crisis Lenders

Table 2 shows the large regional or bilateral players in international crisis lending. Bilateral swap lines were part of the immediate crisis response and at the height of the crisis they proliferated, in particular with the US Federal Reserve. Many of those swap lines with non-core advanced countries and emerging markets have now expired, but we cannot exclude that they might be reactivated in another global crisis. The bilateral swaps between the six core financial centre central banks are now standing lines and unlimited. The bulk of current limited value bilateral swap lines are with the People's Bank of China and have the stated intention of facilitating trade, investment and the international use of the renminbi (IMF 2016a). Bilateral swap arrangements are unconditional since they are to address liquidity issues only, and central banks are not well positioned to impose program conditionality. Nevertheless, bilateral swap lines may serve as a substitute to lending from international or regional institutions in times of global crisis, and would thus undermine their policy framework.

Generally, RFAs can be expected to be softer than global multilateral institutions. This is in part for political reasons, as regional members are close neighbours, and in part for economic reasons, as direct and indirect contagion is usually higher inside a region. Some RFAs (for example, in Asia) were born

Table 2: Different Layers of International Crisis Lenders and Their Debt Restructuring Requirements

Arrangements	Size in US$ billions	Number of Members	Financing	IMF Involvement	Debt Restructuring Requirement
Unlimited Standing Bilateral Swap Lines	unlimited	6	Central Banks	No	No
Limited Value Bilateral Swap Lines (current)	about 550	about 40	Central Banks	No	No
Crisis Bilateral Swap Lines (expired)	NA	10	Central Banks	No	No
ESM	560	19	Member capital + leverage	Not necessary but expected	Not explicit / own Debt Sustainability Analysis)
EU Balance-of-Payments Assistance Facility	56	9	Member capital + leverage	Not necessary but expected	Not explicit
EU European Financial Stabilisation Mechanism	54	28	Member capital + leverage	Yes	Implicit IMF
CMIM/AMRO	240	19	FX Reserves	Not if access < 30% of max	Not explicit
BRICS Contingent Reserve	100	5	FX Reserves	Not if access < 30% of max	Not explicit

Data sources: Denbee, Jung and Paternò (2016), IMF (2016a) and author's calculations.

Notes: AMRO stands for ASEAN+3 (Association of Southeast Asian Nations Plus Three) Macroeconomic Research Office.

out of the desire to provide an alternative to IMF lending and conditionality. Both the CMIM and the BRICS CRA allow drawing up to 30 percent without any IMF involvement. This implies that IMF sovereign debt restructuring requirements would apply in a large crisis only. But even for large cases the new door in the IMF access policy might be used: debt restructuring could be avoided if the RFA provided sufficient (concessional) funding. It is difficult to say how exactly the division of risks and decisions on restructuring versus additional funding would play out. Neither the CMIM nor the BRICS CRA have been tested.

The situation is very different in Europe where there has been ample room for testing these border lines over the last six years. Europe, and in particular the euro zone, hosts by far the largest RFA, the ESM, but thus far the IMF has been involved in every program as a member of the well-known Troika (the tripartite group of lenders that include the IMF, European Commission and European Central Bank). It is also the IMF's painful experience in Europe that has contributed to the hardening of its restructuring requirements over the past years. European institutions and the IMF did not always see the same urgency or need for restructuring Greek debt. The European institutions have developed their own debt sustainability analysis, which differs only marginally from the IMF's (European Commission 2014). For the ESM, however, it is unclear what is to happen in case the sustainability test is not passed with high certainty. A requirement for debt restructuring in such a case is missing in ESM lending policies.

The ghost of Deauville[1] has to take some responsibility for this omission, but the deeper reason likely lies in the still looming debt overhang in parts of the euro zone. When countries already have a debt overhang it is too late for any preventive effects of a restructuring regime. One is left with only the stability issues, since implementing hard restructuring requirements may trigger an immediate run on the debt. Thus, there will be strong and justified resistance to a debt restructuring regime. The only way of fixing incentives for the future is to simultaneously eliminate the debt overhang and implement a restructuring regime. Giancarlo Corsetti et al. (2016) present such a solution for the euro zone. They suggest a concerted debt reduction operation, which would be mainly funded by countries' own future incomes, and a reform of ESM access policy with a hardwired and predictable debt restructuring requirement.

Finally, Europe shows how dealing with the gray zone may play out in the new international financial architecture with multiple

1 In a famous walk on the beach of Deauville, German Chancellor Angela Merkel and French President Nicolas Sarkozy agreed to introduce a debt restructuring requirement in ESM lending. Spreads on sovereign bonds in periphery euro-zone countries rose sharply thereafter.

large players: there may be an inherent conflict between the centre and the region about the shape of the gray zone and the need to restructure. The new exceptional access policy puts the IMF in a strong position to bargain with regional players, since the back door to IMF lending in the gray zone is intended to be used only rarely (IMF 2016d). The IMF may be tempted to play tough, arguing for more and earlier restructuring, the regional official lender will resist and the solution may be more concessional financing by the regional lender. If this correctly describes the new game, then the incentives for debtors to pursue sound policies are further weakened.

Conclusions

The global financial safety net is larger, but may well be weaker in incentivizing prudent economic policies. In particular, there is misalignment of debt restructuring requirements in the lending policies of the various players. Thus, there may be a systematic conflict on this issue between the IMF at the centre and RFAs undermining disciplining and preventive effects of a sovereign debt restructuring regime.

There are two distinct solutions for the inconsistency. On the one hand, the "lower" levels of the financial safety net could align their policies completely with the centre player, the IMF. This would involve a strict framework for the provision of swap lines and an acceptance of IMF involvement and leadership in all programs. Given the present trend toward regionalization and localization, this solution may not be viable. The alternative is that regional arrangements adopt their own lending policies and restructuring requirements that are inside the boundaries of the IMF. This not only avoids conflict among official creditors, but could also be in the interest of regional members, since it overcomes the commitment problems to lend in cases of highly doubtful debt dynamics.

For the euro zone, there is a third option — namely, give up IMF involvement and adopt a clear and predictable debt restructuring requirement for ESM lending in cases of doubtful debt dynamics. This would be a further step toward completing the monetary union by strengthening ESM governance and powers, and improving incentives for prudent policies. The euro zone's troubles also illustrate that the time for fixing systems is when they are *not* under stress. Once a debt overhang has built up the time for prevention is over. Thus, an effective restructuring regime for the ESM could require a simultaneous clearing of the debt overhang. The German G20 presidency would be perfectly positioned to make headway on all of these issues.

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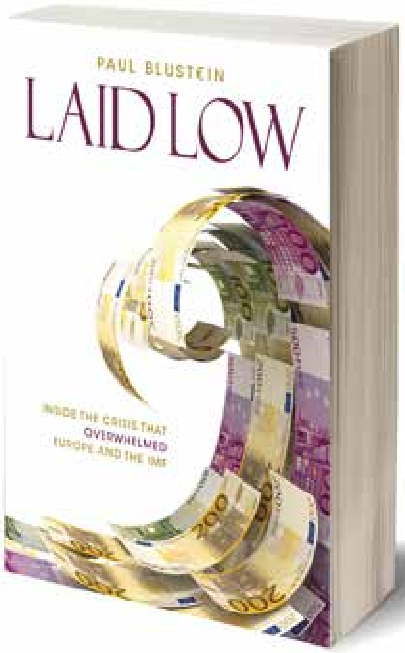

LAID LOW

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By Paul Blustein

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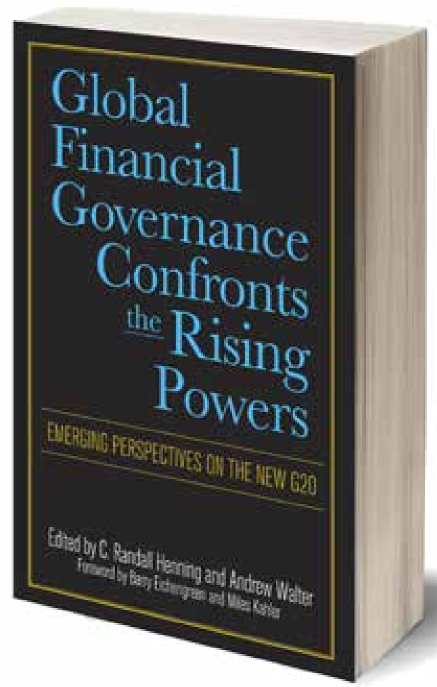

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