Task Force 9
International Finance

Policy brief

POLICIES FOR MANAGING A WAVE OF SOVEREIGN DEBT CRISES*

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Patrick Bolton Graduate School of Business, Columbia University
Mitu Gulati Law School, Duke University
Ugo Panizza Fondazione Luigi Einaudi

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MILANO

ABSTRACT

The international financial architecture is not well equipped to deal with a situation in which many countries default at the same time as a result of an exogenous shock. If all creditors could be coordinated, they would agree that they would benefit from legal protection that allows the affected sovereigns to use their resources to fight the pandemic and get their economies back on track. This policy brief describes options to provide such protection, while also aligning incentives for private creditors. The G20 can play a key role in coordinating the official sector and enhancing private sector participation.

CHALLENGE

Even before the Covid-19 pandemic, many emerging and low-income countries were close to facing a debt distress situation. The collapse in economic activity brought about by the pandemic and the need to redirect money that had been earmarked for external debt service to defray Covid-related expenses has increased the number of countries likely to face debt crises in the coming months.

Although the debt situation of many emerging and low-income countries has deteriorated dramatically, some countries have been able to avoid a full-fledged debt crisis thanks to abundant global liquidity. However, financial markets are fickle. A turn of sentiment could lead to tighter financial conditions and to a wave of debt crises which would trigger an international financial and humanitarian crisis.

Over the past decades, there has been progress in the design of instruments to deal with sovereign debt crises. However, the international financial architecture is not well equipped to deal with a situation in which a large number of countries default at the same time. With sufficient coordination, all creditors can benefit from a debt standstill and restructuring. At the center of such coordination would be a stay on creditor litigation, so that crisis countries can undertake an orderly debt work-out. This is akin to the automatic stay regime under corporate bankruptcy. However, no fast and efficient mechanism exists for sovereign debt, especially to provide a multi-country stay. In the absence of such a legal mechanism, countries that want to divert resources from debt service to health care risk having to fight a plethora of creditor lawsuits. As this requires time and resources, it is desirable if countries could be temporarily protected against lawsuits while they are working out their finances.

On April 15, 2020, the G20 issued a communiqué supporting a Debt Service Suspension Initiative (DSSI) allowing for a suspension of debt service payments for the poorest countries. The DSSI has been extended twice and it is now supposed to expire at the end of 2021. In November 2020, the DSSI was complemented by the G20 Common Framework for Debt Treatments beyond the DSSI which is an agreement of the G20 and Paris Club countries to coordinate debt treatments for up to 73 countries.

The DSSI and the common framework are welcome developments, but they are inadequate along three dimensions:

1. The G20 called upon private creditors, working through the Institute of International Finance (IIF), to participate in the Initiative on comparable terms. However, as of this writing, the private sector has not participated.

2. While explicitly mentioning private sector participation, the Common Framework does not detail concrete measures that could induce the private sector to participate in the

Initiative. Specifically, countries that request a suspension of official debt service are required to ask for a similar treatment from the private sector, but that step does not compel participation by private creditors and does not preclude private creditors from suing debtor countries in default; the Framework does not include any legal mechanism that would prevent such suits.

3. The G20 actions only focus on 73 relatively poor countries; there is nothing in place for the multiple emerging market economies with large stocks of outstanding debt that are outside this group.

Managing future debt problems will require: (i) more broadly based debt suspension; (ii) mechanism that protect countries that adopt debt suspension from generalized lawsuits; and (iii) coordinated debt restructuring for countries with solvency problems. This policy brief mostly focusses on point (ii) which, however, is an essential element for the implementation of points (i) and (ii).

PROPOSAL

In order to involve the private sector and allow for an orderly restructuring in the event of a wave of sovereign debt crises, the official sector needs to provide the private sector with both carrots and sticks.

Bolton et al. (2020) proposed a mechanism to implement a debt standstill which would free significant resources, while also giving private creditors incentives to participate. The proposal envisions the creation of a central credit facility (CCF) allowing countries to stay on payments to official and private creditors.[1] The creation of the CCF would have several advantages: (i) All participating creditors (bilateral and commercial) would be treated equally; (ii) All issues related to the identification of eligible crisis amelioration expenditures would be monitored and administered by a multilateral institution; (iii). Amounts reinvested in a CCF would stand the best chance of being repaid even if the debtor country concerned eventually needs a full-scale debt restructuring.

Sticks are also necessary to avoid holdout problems. In Bolton, Gulati, and Panizza (2021), we put forward the notion of "legal air cover" which aims at temporarily protecting countries against lawsuits. In that context, we explore several options.

We first explore the option of "reverse acceleration" built into some existing debt contracts. This provision allows for a simple majority of creditors to reverse attempts by a minority of creditors to accelerate the debt. In an ideal world, this is the mechanism that distressed countries would use. But these clauses are largely untested and, best we can tell, are not designed to deal with the scenario we described at the outset of the paper.[2] There are several features that make this mechanism unsuitable for dealing with a multi-sovereign default scenario. It is thus unlikely that existing contract mechanisms can produce an immediate and effective stay on litigation in a generalized sudden stop scenario.

Next, we focus on three options which can be put in place quickly, without the need for lengthy legislative wrangling or contract-by-contract and country-by-country negotiations. The air cover they provide may facilitate negotiations with creditors and buy time for conducting debt sustainability analyses, without the fear of a rush to the courthouse. In this sense, the proposed solutions can be useful to deal with both liquidity and solvency crises in a world that still lacks a statutory mechanism for dealing with sovereign defaults.

The first plausible option is a UN Security Council Immunity Shield similar to that used to restructure the Iraqi debt accumulated by Saddam Hussein.

By the time Saddam Hussein had been ousted in the Spring of 2003, the total amount of unpaid claims against Iraq exceeded US$ 140 billion. Approximately US$ 21 billion of the Saddam-era debt stock was owed to a group of commercial creditors including commercial

banks, insurance companies, hedge funds, and trade creditors. The Iraq debt restructuring was both harsh on the creditors and successful. In net present value terms. While Iraq inflicted an 89.75% loss on holders of Saddam-era claims commercial creditors, the participation rate exceeded 96%.

The restructuring process took place under the cover of UN Security Council Resolution 1483 of May 22, 2003, which effectively immunized Iraqi assets from seizure by Saddam-era creditors. Resolution 1483 immunized Iraq's sales of petroleum and related products, as well as the cash proceeds from the sale of Iraqi oil, from "any form of attachment, garnishment, or execution". Resolution 1483 was passed by the Security Council under Chapter VII of the UN Charter. It was thus legally binding on all members of the United Nations.

Among the attractive aspects of the UN Security Council resolution is that it creates worldwide immunity for the assets of the sovereigns in peril and it does so with speed. Only the members of the Security Council have to agree; and that is a small group – the five permanent members and ten non-permanent ones. Of course, this requires agreement from the leadership in these countries; something that is far from certain in the current context of international tensions.

The second option is an executive order by the US President and a similar legislative action by the UK parliament (most international debt is issued under either New York law or English law).

The US implemented the Resolution 1483 immunities through an Executive Order (EO 13303) signed by President George W. Bush on May 22, 2003. That Executive Order was renewed annually thereafter by both Presidents Bush and Obama even after the dictates of the UN Security Council ended in 2011. There was thus a period of three years (2011-14) when an effective immunity strategy was in place through the actions of a single country: the US.

A current example of a US President utilizing his executive power to confer immunity of key assets of a sovereign debtor in default is Venezuela. Here, the US authorities have issued temporary protective orders immunizing Venezuela's ownership interests in Texas-based oil refinery Cigto.

Other examples, arguably even more intrusive into individual rights, are the numerous blanket settlements of the claims of US nationals against foreign governments that have been entered into by various US governments over the years. This confirms that the US executive has broad authority to take actions of the type described above in matters relating to foreign relations, particularly where the actions in question are aimed at dealing with a national emergency. A blanket imposition of temporary sovereign immunity for all emerging market sovereign debtors being pursued in the US courts in the context of efforts to protect against the worsening of a global pandemic crisis strikes us as satisfying the conditions for such emergency action.

As for the other major financial jurisdiction, the UK, a US-style Executive Order is not a likely option. However, in contrast to the US, the UK has shown the ability and willingness to pass protective legislation to help poorer nations against litigation by vulture funds.[3]

The two options described above depend on political will and an inclination on the part of the powerful nations to assist the broader global community. Absent that willingness, or while that willingness is being hatched, more temporary solutions may be required. The third option would rely on the doctrine of Necessity under Article 25 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts.

The scope of the doctrine is narrow. It may only be invoked as a justification to breach obligations if there is "grave and imminent peril" for the citizens of the country in need, and interests on the creditor side that are not "seriously impair[ed]". The defense is also unavailable if the state in question is even partially responsible for causing the problematic state of affairs. Given this latter requirement, the necessity doctrine is rarely applicable. But that is the virtue of the doctrine – it is only applicable in the rarest of circumstances when the country in question is in dire need and is not at fault in causing the problem.

The destruction caused by the Covid-19 pandemic satisfies the above conditions. It is hard to think that any emerging market nation was at fault in any way for causing the pandemic. One might argue at the margins about whether states took the right steps to deal with the pandemic and some have probably taken the wrong steps. But even the worst decisions were presumably made in good faith, with governments trying to balance economics and healthcare. The key to a local court in either the US or the UK applying this doctrine will be whether the Official Sector, along with the governments of those jurisdictions, certify that these are conditions that warrant the applicability of the doctrine. Absent such a certification, getting a local court to take the radical step of incorporating this doctrine is a tough ask.

Bolton, Gulati, and Panizza (2021) provide more details on implementation challenges and feasibility of these options. What is important for the purposes of this policy brief is that G20 support would provide legitimacy and increase the political feasibility of these options to provide legal air cover.

A key issue raised by these latter options is that they involve a degree of ex-post intervention in debt contracts. Under normal circumstances, retroactive modifications of contract terms are disfavored in every modern legal system because they diminish the value of contractual commitments. Ex-post interference with contract terms can however be optimal in exceptional circumstances where the parties themselves – had they been able to negotiate a contract provision ex-ante – would have wanted modifications to the contract. Under these circumstances, ex-post intervention in contracts by the state can be welfare enhancing. For instance, there is evidence that the US government's abrogation of gold clauses in the 1930s, in the context of the Great Depression, did not lead to negative market reactions or spillovers to other asset classes.

The most important recent ex-post contract modification in sovereign debt is the Greek government's decision to retroactively insert collective action clauses in all of its local-law governed sovereign bonds in March 2012. Multiple challenges were brought against the Greek sovereign across a range of international fora with expropriation-type claims being made in each case. In all of these challenges, the courts sided with Greece.

Several observers suggested at the time that this "Greek Retrofit" would reduce faith in the value of contracts across the European Union and, therefore, increase the costs of borrowing for sovereigns in the European periphery. In Bolton, Gulati, and Panizza (2021), we analyze the validity of these claims by conducting a series of event studies aimed at testing whether the court decisions mentioned above had an effect on the borrowing costs of Ireland, Italy, Portugal, and Spain. We find no evidence of negative spillovers leading to a systematic increase in borrowing costs for other vulnerable European sovereigns as a result of the various tribunals upholding the Greek ex-post modification of contract terms. This result supports the idea that, when justified by exceptional events, ex post contract modifications do not necessarily have negative repercussions.

Such interventions are beneficial only if they take place when highly unusual events happen (precisely the events that are hard to contract ex-ante). By certifying that such an event has occurred and by acting accordingly, the G20 can ensure that contract terms will be modified only when absolutely necessary and when the modifications are likely to support credit markets and enhance welfare for both borrowers and lenders.

So far, the majority of emerging and low-income countries have been able to service their debt partly because of massive liquidity injections by central banks in advanced economies. However, the situation may change and the massive increase in debt associated with the pandemic may lead to a global debt crisis. This policy briefs highlight a possible strategy for minimizing the cost of such a crisis, if it were to happen.

NOTES

[1] In the mechanism proposed by Bolton et al. (2020), the official sector coordinates the standstill and ensures that the associated debt relief is directed towards pandemic funding. A multilateral institution such as the World Bank creates for each participating country a central credit facility (CCF) allowing a country requesting temporary relief to deposit stayed interest payments for use for emergency funding. The CCF would specify the eligible expenditures under the facility, as well as the arrangements for monitoring by the multilateral institution the use of proceeds to ensure that the payments that otherwise would have gone to creditors are used for emergency funding. The basic principle is that all creditors will be asked for the same relief – a standstill on interest payments for a prescribed period, since a bespoke implementation of that request will result in choppy, inconsistent outcomes. Each CCF should have terms (interest rate and amortization) that will not aggravate the post-Covid-19 financial position of the beneficiary country.

[2] For detail, see Bolton, Panizza & Gulati (2021).

[3] A different legislative option to deal with the sovereign debt problems that are likely to arise as a result of the Covid-19 pandemic that some others have proposed is to work through the legislature of the state of New York on the logic that a large portion of emerging market sovereign debt is governed by the law of the state of New York. See Gladstone (2021). One problem with this avenue – in terms of producing legal cover – is that the relevant law of immunity in the US has historically been federal since it is the federal government that deals with foreign relations. Hence, attempts by the states to interfere with the immunity rules for foreign sovereigns are likely to face legal challenge and fail.

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ABOUT THE AUTHORS

Patrick Bolton Columbia University, New York (USA)

David Zalaznick Professor of Business at Columbia Business School and Professor of Finance and Economics at Imperial College. He is a NBER and CEPR Fellow.

Mitu Gulati Duke University School of Law, Durham (USA)

Professor of Law at the University of Virginia Law School. He was previously on the faculty of Duke Law School since 2004, and has also served on the faculties of UCLA Law School and the Georgetown University Law Center.

Ugo Panizza Fondazione Luigi Einaudi, Turin (Italy)

Professor of International Economics and Pictet Chair in Finance and Development at the Graduate Institute, Geneva. He is a Vice President of CEPR and a Fellow of the Fondazione Luigi Einaudi, Turin.