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A Path to Positive Debt Workouts

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A messy default and restructuring in an advanced economy would without a doubt provoke a serious systemic crisis. So, now is the time to promote a process with strong incentives for debtors and creditors to reach swift, successful, and sustainable debt restructuring agreements.

Keen focus on debt restructuring is essential. Today, gargantuan government debts are more heavily concentrated in advanced economies than emerging markets – historically associated with crises and presently under stress. Sovereign debt in the major advanced economies now exceeds 90% of GDP – up from only 45% in 2000. So, debt burdens in the developed world doubled in 13 years!

Unfortunately, a new IMF initiative to centralize and control the sovereign debt restructuring process risks sweeping judgments by the Fund at the expense of private sector interests and perspective. [1]

Here, officials must heed lessons from the 1980s to develop the architecture for a successful and sustainable debt resolution process. During the Brady Plan, the private sector was a direct player in the debt restructuring process rather than being merely consulted on the margin. To be sure, active integration of the private sector was a key ingredient behind the success of the Brady Plan and subsequent birth of the emerging markets miracle.

The private sector can be a friend or foe in debt restructuring deals. Voluntary private capital can readily pour back into the sovereign in the aftermath of a fair workout program. In contrast, poorly orchestrated deals often hasten capital flight and worsen real economic disturbances.

So, rather than seek to control and centralize the resolution process, the IMF should actively integrate the private sector into the debt restructuring process via three principles: (1) get the math right, (2) limit IMF financial exposure, and (3) encourage productive negotiations.

Get the Math Right

Recent IMF papers call attention to misestimates of debt sustainability and access to voluntary private capital flows in the Fund's own Debt Sustainability Analysis (DSA) calculations.[2] Despite this acknowledged mixed track record, the new IMF proposal seeks to leave **"discretion to the Fund on when to declare debt unsustainable."**[3]

This would be a mistake. Why would the Fund want to assume more policy responsibility based on poorly performing analytic techniques?

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[1] "Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework" – International Monetary Fund, April 26, 2013.
[2] "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement" – International Monetary Fund, May 20, 2013.
[3] "Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework" – International Monetary Fund, April 26, 2013, page 25.

Misestimates represent a shortcoming of DSA objectives and are reparable. Going forward, DSA models must target growth for the sovereign and active private sector participation in the economy. In this case, both creditors and debtors will be better off. Creditors receive a more valuable asset; while debtors experience payment relief and the opportunity for growth.

To facilitate these objectives, large private creditors must actively participate in the analytic process. Who better to estimate future private sector involvement than those making the decisions?

Private participation in the DSA process was critical for the success of debt restructuring agreements during the Brady Plan. At the time, economic subcommittees (ESC) of bank economists worked closely with sovereigns and the IMF to sculpt mathematical blueprints for the benefit of creditors and debtors alike.[4]

Limit IMF Exposure

A byproduct of IMF involvement in debt restructuring arrangements seems to be ever increasing lending packages. Greece accessed a stunning EUR30 billion. Over the years, IMF lending has steadily advanced from programs offering 300% of quota (a country's share in the IMF) during the Brady Plan restructuring days to 650% in recent crises to now over 3,000%!

Large IMF lending packages carry the unintended consequences of tilting the balance of power in sovereign debt negotiations. No longer is the IMF an impartial participant or neutral arbiter in the resolution process. As the Fund becomes one of the debtor nation's largest creditors, the natural bias is to force the reduction of claims of preexisting debt holders to enhance the credit quality of its new and large loans. In isolation, reduced claims seem a noteworthy objective. However, haircuts must be fair and optimal for sovereigns and creditors alike.

Encourage Productive Negotiations

The IMF must encourage amicable negotiations between the sovereign and its private creditors.

Swift and constructive negotiations often produce the longest lasting arrangements. For example, the last debt restructuring in Chile was rapid and harmonious. Since then, 1990, growth in Chile has exceeded 5% per annum on average. In contrast, the minority of poorly orchestrated deals often ends in strife. More recently, according to a study by Moody's of 34 sovereign bond exchanges since 1997, the average time to complete 31 of the deals was less than 8 months.[5] Three remaining restructurings in the Ivory Coast, Nicaragua, and Argentina took more than 2 years to complete. No wonder problems remain ongoing in Argentina.

The burden should not fall solely on the IMF. The private sector bears much responsibility for boom-bust cycles in markets stretching from sovereign debt to mortgages. Many private market participants invest based on momentum. This over-exuberance or herding often ends with crowded trades, a

[4] Lawrence Goodman, "Solving the Greek Crisis," Center for Financial Stability, June 24, 2011.
[5] Elena Duggar, Richard Cantor, and Bart Oosterveld, "The Role of Holdout Creditors and CACs in Sovereign Debt Restructuring," Moody's Investors Service, April 10, 2013.

sudden stop in the flow of new capital, rapid flight of funds, and desire for bailouts with public funds. This is a poor use of official resources.

Although the IMF cannot alter human investment behavior patterns, it can help creditors and debtors perform more responsibly. The Fund's timing for renewed emphasis on the sovereign debt restructuring process is excellent to foster financial stability by promoting positive debt workouts. However, the Fund must work to create a real partnership with all sides fully represented.

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