Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

RECOMMENDATIONS ON SOVEREIGN DEBT

To: The International Monetary and Financial Committee
From: Peter Orszag
November 2020

Background: In the wake of the COVID-19 pandemic, and despite ample liquidity in most global markets, numerous governments are struggling with debt challenges reflecting not only the current crisis but also the legacy of borrowing during easy global financial conditions over many years. To resolve these restructurings effectively and efficiently, reform rather than revolution is necessary. Six steps would be helpful.

PRIORITY 1: Enhance private sector participation in future short-term debt relief

The International Monetary and Financial Committee (IMFC)[1] should task the International Monetary Fund (IMF) to develop, in coordination with market players and other stakeholders, contingent clauses in debt contracts that trigger an automatic extension or standstill of payments due for a certain time period based on a set of triggers to be defined (and that could involve a declaration from the Fund itself). Governments should be encouraged to issue debts allowing for such standardized conditional short-term relief that would not automatically trigger rating downgrades. Admittedly, this approach is oriented toward future crises more than the current one.

PRIORITY 2: Review the creditor terms set by the IMF itself

The Fund is, more than ever, an anchor for international coordination of all public and private creditors. However, the recent experience in Argentina, which restructured its debts in 2020, highlights a risk that could jeopardize this position: the Fund's own substantial financing role.

It is first worth reviewing whether the interest rate charged by the Fund itself should be reduced in the context of near-zero special drawing right (SDR) interest rates. It is a senior creditor but also receives an interest rate (above 4 percent in current existing programs, slightly below 4 percent in recent new ones) exceeding that of other bondholders post-

Peter Orszag is the CEO of Financial Advisory at Lazard and a member of the board of the Peterson Institute for International Economics.

Disclosures: Lazard advises governments in negotiating with public and private sector creditors on debt sustainability issues. Most recently, it advised Argentina and Ecuador in negotiating successful debt restructurings and assisted several countries in benefiting from the G20 supported Debt Service Suspension Initiative (DSSI).

1 The IMFC is a 24-member board of central bank governors, ministers, or others of comparable rank that advises and reports to the IMF Board of Governors on the supervision and management of the international monetary and financial system.

1750 Massachusetts Avenue, NW | Washington, DC 20036-1903 USA | +1.202.328.9000 | www.piie.com

restructuring. Such elevated margins were intended to make the Fund's exceptional access lending framework less appealing to borrowers, but conditionality associated with this lending already plays a crucial role along that dimension.

In addition, to avoid excessive debt being held on the balance sheet of the Fund, the IMFC should encourage the Fund, beyond certain specified funding quotas, to cofinance a program rather than to finance entirely through its own balance sheet. In such circumstances, the Fund would for example turn to a group of sovereign wealth funds (SWFs) to provide cofinancing.

PRIORITY 3: Develop guidance on value recovery instruments

IMF staff technical assessments of debt sustainability play an essential role in setting the stage for debt restructuring negotiations. A conservative approach towards future economic growth assumptions in the debt sustainability analysis could be combined with contingent securities that pay out if economic activity exceeds the assumed levels. The Fund should provide guidance on various mechanisms for such value recovery instruments (VRIs) to overcome criticisms addressed against various bespoke instruments currently in existence. The VRIs could provide payments to creditors based on certain indicators such as GDP, export levels, commodity prices, and so on.

PRIORITY 4: Promote efficiency in debt negotiations with private creditors

Over recent decades, the IMF has played a key role in promoting a collaborative and efficient participation of private creditors in debt restructurings. Part of that role involves promoting the standardization of collective action clauses (CACs) in debt contracts to limit the ability of litigating creditors to block a restructuring.[2]

New generation CACs proved efficient in the most recent debt restructurings, protecting debtor countries from the risks associated with holdouts and litigating creditors. But at a time when debt restructurings could become more frequent than in the past, further reforms could prove useful. The IMF should support a lower threshold for so-called single-limb aggregation methods under CACs and also loosen the constraints around the "uniformly applicable condition" when deploying the single-limb method.

PRIORITY 5: Enlarge the Paris Club to include China

For years, the Paris Club of sovereign creditors has been essential to ensuring an efficient coordination of lender countries (most of them from the Organization for Economic Cooperation and Development) and a good coordination with the IMF for the resolution of debt crises. Over the past 20 years, China has emerged as a very large lender to developing countries.

The time has come to integrate China fully into the Paris Club. Such a change would make the debt restructuring process considerably more fluid and effective. While the Paris Club traditionally takes decisions based on consensus, China, as the dominant bilateral creditor, could be promised for a few years that the agreement of a block representing at least a 60 percent share in a debtor country's bilateral debt is required to make decisions.

2 Such CACs force an entire class of bondholders to accept a restructuring if a sufficient share of creditors, rather than all, accept the terms.

PRIORITY 6: Update prejudgment interest rates in key jurisdictions

Although under the jurisdiction of local authorities, the interest rate charged on civil litigation matters can materially affect sovereign debt negotiations. For example, many sovereign debt disputes are ultimately subject to New York state law. Since 1981, New York Civil Practice Law and Rules has set the prejudgment interest rate for civil litigation at 9 percent, a rate that today is in material excess of prevailing market interest rates.

Nominal interest rates were much higher in 1981, when the New York rate was set. Tying the prejudgment rate to current market interest rates, as represented by US Treasury yields, would normalize it while allowing for it to track the cost of debt over time. The IMFC should support a market-based interest rate applied to prejudgment disputes about sovereign debt.