A Step Forward on Sovereign Debt

Anna Gelpern assesses the International Monetary Fund's proposals for debt agreements aimed at averting disputes like the one that has plagued Argentina and its creditors.

Steve Weisman: When a country defaults, it's not a pretty site as creditors fight over who should get paid and how much they should get paid. That was the case in Argentina, but other cases have come to the fore and caused the International Monetary Fund to propose new rules. Anna Gelpern, nonresident senior fellow at the Peterson Institute, is here with me, Steve Weisman. Anna, what did the IMF do?

Anna Gelpern: The IMF, after the debt crisis in Greece and then the lawsuits against Argentina, revisited quite broadly its policy on government debt restructuring. There are three prongs to this reassessment. They thought about how to figure out whether a country has too much debt and needs a debt restructuring. They then put out a paper on how to condition the IMF's own loans on a country managing its debt burden. And then this latest paper, which was just made public yesterday [Oct. 6] and was discussed in the IMF board a week ago, is about what the debtors and the creditors can do in the contracts among themselves to make debt restructuring smoother and to reduce the chances of a litigation fest of the sort that we saw in Argentina over the last couple of years.

Steve Weisman: It sounds to me sort of like a prenuptial agreement for the marriage between borrowers and lenders. What innovations did they suggest?

Anna Gelpern: It is exactly like a prenuptial agreement.

Steve Weisman: Not that we have any experience with that.

Anna Gelpern: Nope. But nevertheless, it's a terrific analogy partly because sovereign governments don't have recourse to bankruptcy, right? So, this is sort of like a world with this profound commitment and no divorce and no procedure to sort out who owns what when things go wrong. The IMF, this time, proposed several very targeted changes in the debt contracts.

The first one is a majority voting procedure. This is simply a way for the creditors of the government to vote to amend the terms of the debt. The new change here is that the creditors are not voting bond by bond by bond, but rather the entire body of the government's bond creditors would have the opportunity to vote on a restructuring.

Steve Weisman: This would be prospective, not governing existing debt?

Anna Gelpern: Absolutely. And this is also significant because as the IMF pointed out, about 40 percent of the most vulnerable debt has maturity of more than 10 years. So, it will be some time before all these contract changes take effect. But if and when they do, the significant thing here is that it will be much harder for a small group of creditors to buy up a blocking position in a small bond issue and then drop out of the restructuring and sue the debtor after everybody has gone in and blocked payments on the new debt.

Steve Weisman: Which is what happened in Argentina.

Anna Gelpern: Which is precisely what happened in Argentina, which brings us to the second change that they recommended. The second change is to clarify a clause, which has been in sovereign debt contracts for way over a century, which promises some form of equal treatment among creditors, but there's a huge debate about what it means.

In recent years, Federal court, sitting in New York, interpreted that provision in the case against Argentina to mean that Argentina cannot pay its restructured debt unless it also pays its defaulted debt in full. And of course, this led to more people getting unpaid. The default on $28 billion, which is impacting a lot of innocent bystanders, notably the people of Argentina and banks all over the world that have been processing the payments.

So both those changes are very targeted. It's not regime change, but it is a very sound and practical move to fix obvious problems that most people agree have manifested themselves recently.

Steve Weisman: Are these changes likely to be adopted by governments issuing debt?

Anna Gelpern: Funny you should ask, because on the same day as the IMF paper was made public, we have news of the first adopter. It's not a very obvious first adapter. It's Kazakhstan, who just went to market with a new bond. And, that bond has been kind of stop and go, they'd been planning to return to the markets for a while and they happened to do it now. So, you wouldn't expect a lot of experimentation on such an issue, and yet, they adopted the very clauses that the IMF recommended.

Now, there is a good explanation for this. The IMF's proposal was very closely coordinated with market participants, the International Capital Markets Association, that of course we wrote about a month or so ago. They proposed model clauses that are referenced in this IMF paper and that were closely coordinated with Fund staff working on these issues. There was a working group at the US Treasury, that I was a part of, that helped get fairly broad buy-in for the idea that certain changes are necessary and there was a wide-range in consultation by the International Capital Markets Association that helped solidify this buy-in.

So, unlike the last times in the 1990s and early 2000s, where it really took quite a long time for the official sector to persuade market participants to change their contracts, this seems to be moving rather fast. One note of caution, the first mover does not equal a market shift. Just because Kazakhstan moved and nobody is expecting it to be penalized for this in terms of the bond pricing, it doesn't mean everybody else is going to go.

Steve Weisman: As Kazakhstan goes, so goes the world, right?

Anna Gelpern: That would be nice. There is also an important thing here, which is Kazakhstan is in London, right? The Argentina vulnerability manifested itself in New York.

Steve Weisman: Meaning, they issued the debt in London.

Anna Gelpern: They issued the debt in London under English law; the biggest problem we've seen in recent years was under New York law in the United States. And I think it will be an even bigger deal perhaps.

Steve Weisman: If they go to New York.

Anna Gelpern: Yes.

Steve Weisman: Is this likely or not likely to change the cost of issuing debt?

Anna Gelpern: You know, about a decade ago, maybe 12 years ago, there was an enormous debate about it and lots and lots of studies about it. And, frankly, the results have been inconclusive. My sense is that people concluded that it is not likely to change the cost of issuing debt. This is a procedural device that actually gives more power to the majority of creditors and limits the possibility of free riding. No debtor will default on its debt because it has a clause on page 35 of its debt contract that might make it easier 10 years down the line.

Steve Weisman: It's a good step forward.

Anna Gelpern: Absolutely. It's a pragmatic targeted step forward. It doesn't fix everything, not even close, but what a good thing to happen.

Steve Weisman: Anna, thanks very much.