Sovereign debt crises tend to trigger calls for sovereign bankruptcy. In the postwar era, a first round of such calls coincided with the great Latin American debt crisis of the 1980s. A second round accompanied the post-Brady debt crises, beginning with the 1995 Mexican crisis and particularly Russia’s 1998 default, and leading to the International Monetary Fund’s 2001 proposal for a Sovereign Debt Restructuring Mechanism (SDRM), which was intensely debated and finally rejected by IMF shareholders in April 2003. Since 2010, calls for some form of international sovereign bankruptcy regime have returned. These have been motivated partly by events in Europe, but also by difficulties in restructuring stubbornly high debt levels in other parts of the world, such as the Caribbean Sea Basin, and by ongoing litigation that could make such restructurings even harder.

This report revisits the case for a sovereign bankruptcy regime, understood as a mix of national and international institutions that would, in some conditions, sanction a comprehensive modification of sovereign debt contracts, and extend legal protections to the sovereigns and creditors involved. It formulates the economic trade-offs involved with creating such a regime, explains why and under what conditions the regime could improve welfare, and presents options for implementing the regime. Its main conclusion is that the intellectual case for—and feasibility of—a sovereign debt workout mechanism based on some combination of national statutes and international treaty is much stronger now than it was 10 or 20 years ago. This is especially true for the euro zone, where the case for such a regime is particularly strong and its implementation as a complement to the existing European Stability Mechanism would be comparatively straightforward.

As background for the logical structure of this report, it is useful to briefly recall the SDRM discussions of the early 2000s. The main focus of this debate was the perceived trade-off between ex-post and ex-ante efficiency. SDRM proponents based their proposal on ex-post inefficiency, exemplified by the successes or near-misses of holdout creditors in cases against Brazil and Peru. The argument was that if creditors could expect holdout strategies to pay off, free riding would become
overwhelming, rendering orderly debt restructurings unfeasible. Conversely, SDRM critics focused on ex-ante efficiency. They argued that since governments could not be easily forced to pay their debts, sovereign debt was feasible and affordable only because sovereign debt crises were costly. A sovereign debt restructuring mechanism whose express purpose was to lower the cost of debt crises might do more harm than good by lowering incentives to repay and sharply raising the cost of debt.

In principle, there was a way of balancing the trade-off between ex-post costs and ex-ante incentives: an SDRM involving a “double trigger”—namely, the debtor country would be able to make a request for assistance (analogous to filing for bankruptcy protection), and a bankruptcy court-like institution could reject frivolous requests. However, from the perspective of SDRM critics, this solution had two weaknesses. First, private creditors might not trust the bankruptcy court—particularly if it were the IMF, which was viewed as both susceptible to political pressure and subject to conflicts of interests through its own role as a large creditor. Second, perverse incentives created by lower crisis costs might extend beyond incentives to repudiate—encompassing a broad range of precrisis policies that influenced the chances of getting into debt-servicing difficulties. Hence, to create good incentives for debtor countries, an international bankruptcy court would need to not only distinguish between an “ability to pay” and a “willingness to pay” crisis but also judge whether an “ability to pay” crisis was mainly the fault of the country or the result of bad luck. This was viewed as a tall order for any institution—particularly those that might not be fully independent, and that might be sympathetic to a country’s plight regardless of its causes.

The SDRM was rejected in 2003, in part because the United States and large emerging market borrowers could not be convinced that its ex-post benefits outweighed its ex-ante risks, and partly because the ex-post costs of the status quo did not seem intractable at the time; most debt crises since the mid-1990s had been resolved fairly quickly without statutory bankruptcy, and did not lead to litigation by holdouts. Those who worried about holdouts, in lieu of a treaty change, got market-wide contract reform, whereby collective action clauses were introduced in most New York law bonds issued beginning 2003. This was rationalized as a small step toward a more ex-post efficient resolution, which was unlikely to upset markets ex ante (and it did not).

Since 2003 there have been three developments that add to, and might have changed the balance of, the set of arguments outlined above. First, research on sovereign debt problems has evolved to take a broader and somewhat different view of the “ex-ante problem.” As an empirical matter, the traditional enforcement problem seems to be overshadowed by moral hazard problems of a different kind. Debtor countries have control over key factors—their debt levels, debt structure and prospects for economic growth—that determine their ability to pay. Additional moral hazard problems may be created at the expense of third parties. These problems can result in overborrowing, along with delays in seeking unavoidable sovereign debt restructurings. The consensus seems to have shifted away from the fear that countries might restructure opportunistically to the fear that they might restructure too late, and that these restructurings might not be deep enough. This has fundamental implications for the debate on sovereign bankruptcy: If the main problem in sovereign debt is not repudiating debtors and overly tight borrowing constraints, but rather overborrowing at the front end and procrastination at the back end, then the old trade-off between ex-ante and ex-post efficiency no longer holds, at least within some range. Lowering the costs of debt crises ex post might benefit efficiency ex ante.

Second, the holdout problem has experienced a rejuvenation. One of the arguments against the SDRM was that it was a heavy-handed way of addressing a problem—coordination failures in debt restructuring—that could be solved easily using procedures and legal techniques that debtors could
invoke unilaterally. For example, take-it-or-leave-it debt exchange offers, backed by minimum participation thresholds and exit consents, allowed debtors to strip holdouts of enforcement weapons with the agreement of a simple majority of bondholders. However, recent court rulings against Argentina in New York give creditors tools to overcome such tactics. At the same time, bond contracts have developed to require supermajorities for the most powerful exit amendments, which are no longer as potent a solution as they were in the restructurings of the early 2000s. Further, investors pursuing holdout strategies have become increasingly effective, as a function of both their financing and their legal sophistication. As a result, successful debt restructurings have become harder to achieve, even if they are in the interests of both the debtor and a large majority of creditors.

Third, the important special case of the euro area now looms large. This has characteristics that both aggravate the ex-ante problem and increase the plausibility of a statutory solution. The close economic, financial and political linkages inside the euro zone—including, perhaps most important, the threat that a sovereign default might trigger a costly exit from the single currency—make the members of the common currency area much less willing to risk a failed debt restructuring in their midst. On top of this, the lack of monetary and exchange rate instruments at the country level makes it harder for these members to address growth and competitiveness problems without external support. For both reasons, the euro zone suffers a more severe moral hazard problem than, say, the potential moral hazard caused by IMF crisis lending. This may contribute to mispricing, overborrowing and delays in needed sovereign debt restructuring, as occurred in Greece. At the same time, because so many areas of economic policy in the European Union, and particularly in the euro area, are already governed by common statute, a statutory approach toward sovereign bankruptcy may stand a better chance in the euro area than elsewhere.

The remainder of this report follows the structure of these three arguments. We begin with a survey of shifting views on the pathologies in sovereign debt. We next discuss the impact of recent litigation and changes in bond contracts on ad hoc debt restructurings. This is followed by a chapter that argues why a more systematic approach to sovereign debt restructuring might be particularly needed in the euro area. The final chapter presents a number of proposals that could address the problem. These include a proposal to modify the 2012 treaty establishing the European Stability Mechanism (ESM) to require debt restructuring as a condition of ESM assistance in predefined circumstances, and to immunize the assets of those countries that have undergone ESM-sanctioned restructurings from attachments by holdout creditors. At the broader international level, the report presents and discusses three alternative options—two that would involve contractual or statutory changes in major borrowing jurisdictions, and one involving an IMF-based restructuring mechanism. The latter envisages endorsement of a sovereign debtor’s restructuring proposal by both a majority of creditors and the IMF. Following this double endorsement, the debtor’s assets would become immune from attachment in the jurisdictions of IMF members.

The report does not discuss two important topics. First, because it focuses on sovereign debt, it does not deal with how to unwind or prevent excessive debts incurred in the private sector. However, the links between these problems and sovereign debt problems are briefly discussed in the context of the euro area (chapter 3). The argument is that while the proposals made in this report will not by themselves solve private sector debt problems,
they may ameliorate them; markets will be more likely to “price” sovereign default risks regardless of whether these originate from sovereign debt or socialized private debt. This should give incentives to sovereigns to worry more about credit booms that could give rise to quasi-fiscal liabilities. While the proposals in this report and plans to create a euro area–based Banking Union address different problems, these problems are linked, and the proposals should be viewed as complementary.

Second, we do not discuss a class of ideas that have broadly similar aims as the proposals in this report, namely, how to prevent sovereign debt crises through debt contracts with equity-like features, for example, by indexing repayments to gross domestic product (GDP) or commodity prices. Although we are sympathetic to these ideas, for the purposes of the present report we take it as a given that in spite of periodic calls, bonds with these features do not play an important role in sovereign finance, and are unlikely to play such a role anytime soon—in part for reasons analyzed in chapter 2.

The focus of this report is on mechanisms that are plausible today—mechanisms that would allow for the swift renegotiation of debt under certain conditions, in ways that not only make crises less costly but also encourage sovereign debtors and creditors to act more responsibly in normal times.

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