The Political Economy of External Debt Restructuring

LMIC external sovereign debt restructuring

- Not a new phenomenon. But form has varied across time
- Currently, stress and default leads to an IMF programme embodied in a staff level agreement based on a DSA
- IMF Board sanctioned following financing assurances from bilateral creditors
- Negotiations with private creditors, including private bondholders
- Comparability of treatment consensus
- Completion of restructuring

IMF sets the 'standard'

- IMF specifies a restructuring programme, defines the overall "haircut" and debt relief needed, and distributes the burden of restructuring across creditors.
- Assumption: markets are not the best judge of the appropriate haircut given risks taken by creditors?
- If discounts in secondary markets for debt of distressed or defaulted borrowers are an indication, bondholders have in most IMF-led restructuring cases got a very good deal.

The historical ‘standard’

- Brady Plan of March 1989 which followed the failed Baker Plan that sought to get the banks and IFIs to resolve the problem.
- The identification with Treasury Secretaries, James Baker and Nicholas Brady indicates mediation by the US state.
- Under Brady, debt holders were offered two options: the exchange of bad loans for either Par Bonds or Discount Bonds.
- Par Bonds, or bonds of equal face value, carried a fixed, below-market rate of interest. Discount Bonds allowed for immediate debt reduction, with a market-based floating rate of interest.

The “innovation”

- Principal of both bonds secured at final maturity by a pledge of 30-year zero-coupon U.S. Treasury securities. A portion of the interest payable on Par and Discount Bonds also secured.
- US Treasury zero-coupon bonds, held in an Escrow account, purchased by the debtor country using proceeds from loans given by the IMF or the World Bank, or the country’s own foreign currency reserves.

Implication

- A haircut was accepted in return for an assurance of repayment.
- Brady deals, which temporarily managed the 1980s debt crisis in 17 debtor countries, involved a high average haircut of 45%.
- Since this was an early experience involving mainly overexposed commercial banks, negotiating this deal was easy.
- The ‘success’ of that reduced fears of likely large losses.
- On the other hand, the subsequent fragmentation of the creditor community, especially with the entry of private bondholders, made hold-outs more common, necessitating lower haircuts for a ‘deal’.

The state in market-based restructuring

- In this process, countries repurchased their debts at a discount by paying cash or by giving creditors equity in domestic industries. But here too government's wanted to bail out banks and get them a good deal.
- So though restructuring appeared to hurt banks because of the haircut, banks responded enthusiastically.
- Consider the Bolivian restructuring of March 1988.

Bolivian case

- In late 1986, $670 million in debt to commercial banks guaranteed by the Bolivian government was trading in secondary markets at six cents on the dollar—if a trade could occur.
- But using funds that primarily were secretly “donated” by “neutral” third countries—rumoured to include Spain, the Netherlands, and Brazil—Bolivia’s government spent $34 million in March 1988 to buy back $308 million worth of debt at eleven cents on the dollar.
- That was the price quoted after the repurchase. So, before the buy-back, banks expected to receive a total of $40.2 million (.06 × $670 million). After the buy-back, banks had collected $34 million and their expected future repayments were still $39.8 million (.11 × $362 million).

Changes in the sources of cross-border debt flows

- Official flows from members of the Paris Club of creditors have declined, and official flows from these countries are mediated through the multilateral financial institutions.
- Sharp rise in private capital flows, from commercial banks and private bondholders in search of yields.
- Significant increase in bilateral flows from China to the deficit-burdened less developed countries.

Enter the IMF as arbiter

- IMF has taken the role of the Treasury as the resolution professional or agent of choice of global finance
- So, debtor countries have no option but accept its programme for a small amount of bridge finance.
- The IMF's intervention has two components: fixing what it considers the level of sustainable debt; and defining the path to it. Adhering to both, while not delivering recovery and balance of payments sustainability, involves severe austerity.

Implications for restructuring

- Paris Club members who control the multilaterals do not contribute much by offering “financing assurances”.
- China which has little influence over the IMF is called upon to go along with its prescriptions on burden sharing.
- MDBs refuse to share debt relief or rescheduling burdens, as that would affect ‘AAA’ credit ratings.
- Private creditors, whose ‘thirst for yield’ and failed ‘due diligence’ requires a haircut, hold out. Their demands influenced by the ‘floor’ to the haircut set by the IMF’s DSA.

Impact: Sri Lanka

- In Sri Lanka’s case the IMF suggested that private creditors should offer a net haircut equal to around 30 per cent of the nominal value of debt, which became the benchmark.
- At the height of the debt crisis, Sri Lanka’s ISBs were reportedly trading at less than 40 cents to the dollar, implying a market-determined haircut of as much as 60 per cent.
- Reportedly, full details of the DSA’s calculations were not known to bilaterals when discussing financing assurances.

“Value recovery”

- Unlike the bilateral creditors, private creditors prefer an upfront haircut, and a short restructuring time table with high market related interest rates..
- The other element was the use of some value recovery instrument. This kind of link has taken an altogether new form in the Sri Lanka restructuring deal with so-called “macro-linked bonds”. They specify that if Sri Lanka’s economic performance, according to some chosen indicator/s, betters that projected in the IMF’s DSA, then an adjustment of debt service payments would reduce the size of the haircut.

Some problems

- According to the official estimates, the total of value of the new bonds of $9.036 billion reflects a 28 per cent haircut relative to the value of existing bonds. The value of the bonds being restructured is placed at $12.5 billion. Adding the bonds issued to cover PDI as well as the consent fee, the amount being repaid in cash or through new bonds amounts to $10.94 billion (excluding interest). The relief that Sri Lanka gets is less than 13 per cent.
- If the Sri Lankan currency, which collapsed during the crisis, appreciates significantly vis-a-vis the dollar, the benchmark nominal GDP in US dollars can be exceeded leading to VR.

Extracting other concessions

- An unusual feature of Sri Lankan deal was carefully tucked away in the bond exchange agreement.
- This was acceptance of "a mechanism to change the governing law of the New York law governed new securities to English or Delaware law with the consent of a supermajority of bondholders if proposed by holders of 20% of any particular series of the new securities."
- Basically meant that, on the basis of a request from 20% of holders of any series, a vote can be held to change the jurisdiction if a "supermajority" of holders agrees.

Ghana

- Ghana has agreed a deal that cuts 37 per cent off the value of $13bn in international bonds.
- Bondholders will give up $4.7bn of their original claim
- Most of the bonds will be restructured into debts with longer maturities that pay interest of 5 per cent over the next four years. Some part will not be subject to a reduction in face value but will carry lower interest rates of 1.5 per cent.
- Brady is obviously not with the IMF today!

Zambia

- Bondholders took a direct cut in the face value of their claim of 22 per cent of their overall claim, based on the 5 per cent discount rate that official creditors use.
- Bondholders will also extend repayment dates.
- They will receive better terms on a portion of the bonds if the IMF judges that the Zambian economy can carry more debt in the years ahead or performance beats the fund's key targets.

The irrationality of restructuring

- Experience has shown IMF-style restructuring does not work.
- What is in it for the bondholders?
- A lower than market-determined haircut
- The increased likelihood of austerity which could by curtailing imports release foreign exchange to help service restructured debt.
- The possibility that gross financing needs targets would necessitate privatization of public assets.