Emmanuel Tumusiime-Mutebile: Global perspectives on sovereign debt restructuring

Comments by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, Kampala, 7 August 2014.

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I would like to thank Mr. Otieno for a very insightful and thought provoking paper. As Mr. Otieno noted, the HIPC and MDRI debt relief initiatives had brought down external public debt levels substantially by the mid-2000s in those African countries which had access to debt relief. At that time, the recipients of external debt relief agreed to curtail future external borrowing, especially on non-concessional terms, usually under the auspices of an IMF programme. However, as pointed out by Mr. Otieno, since the mid-2000s, sovereign borrowing has accelerated, and now includes borrowing on semi concessional and even fully commercial terms. Three factors lie behind the increase in external borrowing by African countries. First, many countries have large needs for public investment which cannot be financed without increased borrowing. Secondly, in real terms, the economies of SSA were more than twice as large on average in 2013 than they were in 2000, because of annual real growth of GDP averaging 5.6 over this period. This growth has raised the capacity of African economies to service debts and thus raised the amount of public debt that they can safely contract without risking running into problems of debt sustainability. Finally, because of developments within global capital markets, notably the very low interest rates and abundant liquidity, some African countries are now able to access commercial debt at reasonably attractive rates.

Nevertheless, we should not be complacent about the dangers of too large and rapid a build-up of sovereign debt. It would be unwise to ignore the possibility that African countries will never again have to seek debt relief in the future. As such we need to think very carefully about the modalities through which sovereign debt relief might be applied in circumstances where sovereign debt is very heterogeneous, comprising traditional concessional debt from multilateral financial institutions, semi concessional debt from official bilateral and multilateral lenders, and commercial debt which includes both borrowing from banks and sovereign bond issues.

As the recent dispute between the Argentine Government and vulture funds which had purchased Argentine sovereign debt at a discount but now demand repayment in full, has reminded us, the world lacks an effective framework for ensuring that, in cases where Governments cannot realistically service their debt in full, their sovereign debt can be written down in a comprehensive and equitable manner which applies to all creditors. This lack of an effective debt restructuring system at the international level encourages free riders such as vulture funds to exploit the generosity of other creditors who provide debt relief, which in turn reduces the incentives on all creditors to accept a reduction in their claims on the sovereign. Because of the growing diversity in the creditor base of African sovereign borrowers, coordinating debt relief among creditors and enforcing compliance will become ever more difficult.

Mr. Otieno discusses the two alternative approaches which have been put forward to restructure sovereign debt in an orderly manner in the event that the debtor faces debt distress: the Statutory Approach and the Contractual Approach.

I concur with Mr. Otieno that the Statutory Approach, such as the Sovereign Debt Restructuring Mechanism (SDRM) which was proposed for the IMF in 2001 has many advantages. The SFRM would have been a form of international bankruptcy regime. In principle it would meet the needs of developing countries for a comprehensive mechanism for restructuring their debt in an orderly manner if the need arises. I think the concerns expressed by some opponents of the SDRM, that it will encourage moral hazard among

debtors, are overblown. Sovereign borrowers do not lightly seek debt relief, because they understand the consequences for their reputation and thus for future access to, and cost of, finance. Moreover, the fact that the terms of any debt relief provided under the SDRM would be determined by a Sovereign Debt Dispute Forum comprising reputable and independent arbitrators should ensure that debt restructuring is fair to both creditors and debtors.

Unfortunately, it appears unlikely that the SDRM or anything like it which has statutory authority will ever get off the ground, because it would require changes to the IMF's Articles of Agreement. There is entrenched opposition to such changes from major shareholders of the IMF such as the United States.

The Contractual Approach, such as that embodied in collective action clauses (CAC) inserted into bond contracts is more practical. It is decentralized and market based and does not require political agreement at the international level for statutory changes. As Mr. Otieno notes, bonds with collective action clauses have already been issued by some emerging markets. CACs can solve the collective action problem for those bonds to which they apply, but the mere fact that a bond contains a CAC does not necessarily mean that a majority of bondholders will vote to offer sufficient debt relief to ensure that the debtor can return to debt sustainability.

Moreover, the relevance of bonds which include CACs for African sovereign borrowers may be rather limited. International sovereign bond issues are still a relatively minor component of the public debt of most African countries, and many countries on the country have yet to issue any sovereign bonds on international markets. The majority of African sovereign debt is still held by multilateral financial institutions. As such the multilateral financial institutions will have to take the lead in offering debt relief, but this then gives the private sector bond holders less of an incentive to agree collectively to offer any substantial debt relief. In effect, the smaller is the share of sovereign bonds in total public debt, the greater is the incentives facing private sector bond holders to free ride on the generosity of the multilateral financial institutions which hold the bulk of the debt.

I agree, therefore, with Mr. Otieno that the CACs cannot be seen as a substitute for a coherent and comprehensive international debt restructuring framework, however distant the prospect of such a framework is. One possible advance on the CAC which maintains the Contractual Approach to the problem might be to issue Contingent Convertible debt; sometimes called sovereign cocos. These are bonds which include a clause to allow for the automatic rescheduling of debt repayments in the event that the debtor seeks official assistance (e.g. from the IMF) because of debt problems. The drawback with sovereign cocos is that they would only allow for a rescheduling of debt repayments rather than a reduction in debt, and so may not provide sufficient debt relief to bring about a permanent resolution of the debt problem.

Mr. Otieno concludes by asking the question “Which Way for Africa?”. He argues that the natural choice for Africa should be the statutory approach, given that multilateral and bilateral creditors hold most of Africa's sovereign debt. I agree that a statutory approach is preferable, but as I have already explained, I doubt whether a comprehensive international framework, which can cover all classes of creditor and enforce compliance by them all, will ever be put in place, given the obstacles it would face from major powers. The way forward will thus probably involve innovations at the global level for coordinating debt relief among multiple types of creditors which fall short of having full statutory authority throughout the world – such as the proposed Sovereign Debt Adjustment Facility in the IMF – combined with the more widespread adoption of contractual mechanisms to provide contingent debt relief linked to the provision of official assistance.