

Gouging the Gauchos

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Like individuals, corporations, and other private firms that rely on bankruptcy procedures to reduce an excessive debt burden, countries sometimes need orderly debt restructuring or reduction. But the ongoing legal saga of Argentina's fight with holdout creditors shows that the international system for orderly sovereign-debt restructuring may be broken.

Individuals, firms, or governments may end up with too much debt because of bad luck, bad decisions, or a combination of the two. If you get a mortgage but then lose your job, you have bad luck. If your debt becomes unsustainable because you borrowed too much to take long vacations or buy expensive appliances, your bad behavior is to blame. The same applies to corporate firms: some have bad luck and their business plans fail, while others borrow too much to pay their mediocre managers excessively.

Bad luck and bad behavior (policies) can also lead to unsustainable debt burdens for governments. If a country's terms of trade (the price of its exports) deteriorate and a large recession persists for a long time, its government's revenue base may shrink and its debt burden may become excessive. But an unsustainable debt burden may also result from borrowing to spend too much, failure to collect sufficient taxes, and other policies that undermine the economy's growth potential.

When the debt burden of an individual, firm, or government is too high, legal systems need to provide orderly ways to reduce it to a more sustainable level (closer to the debtor's potential income). If it is too easy to default and reduce one's debt burden, the result is moral hazard, because debtors gain an incentive to indulge in bad behavior. But if it is too difficult to restructure and reduce debts when bad luck leads to unsustainable debts, the result is bad for both the debtor and its creditors, who are better off when a reduced debt ratio is serviced than when a debtor defaults.

Finding the right balance is not easy. Formal legal bankruptcy regimes for individuals and firms have evolved over time to accomplish this.

Because a formal bankruptcy regime for governments does not exist (though Anne Krueger, the International Monetary Fund's then-deputy managing director, proposed one more than a decade ago), countries have had to rely on a market-based approach to resolve excessive debt problems. Following this approach, the country offers to exchange old bonds for new bonds with a lower face value and/or lower interest payments and longer maturities. If most investors accept this offer, the restructuring occurs successfully.

But this implies a key problem: Whereas a bankruptcy court can force holdout creditors to accept the exchange offer as long as a significant majority of creditors have already done so (a so-called “cram down”), the market-based approach allows some creditors to continue to hold out and sue to be paid in full.

That is why, over the last decade, governments have augmented the market-based approach with a contractual approach that resolves the holdout problem by introducing collective-action clauses (CACs) that can also cram down on holdouts the terms accepted by a majority of creditors. These clauses became standard in sovereign bonds but were missing in those issued by Argentina before 2001, when the crisis hit. Though 93% of Argentina’s creditors accepted new terms for their bonds in 2005 and 2010 in two exchange offers, a small group of holdouts sued Argentina in the United States, and, with the US Supreme Court recently ruling on the issue, have now won the right to be paid in full.

The US court decision is dangerous for two reasons. First, the court ruled for the first time that a country cannot continue to pay those creditors who accepted a big reduction (or “haircut”) on their claims until the holdouts are paid in full. So, why would any future creditor who benefits from an orderly restructuring vote for it if its new claims can be blocked by even a single holdout creditor?

Second, if the holdouts are paid in full, the majority of creditors who accepted a haircut can request to be paid in full, too. If that happens, the country’s debt burden will surge again, become unsustainable, and force the government – in this case Argentina, which is servicing most of its debt – to default again on all creditors.

The inclusion of CACs in new bond contracts may help other countries avoid the holdout problem in the future. But even CACs may not fully help, because they are designed in a way that still allows a small minority of creditors to hold out and thus prevent an orderly restructuring.

Either super-CACs need to be designed and introduced (though it will take years to include them in all new bond contracts) or the international community may want to reconsider whether the 2002 IMF proposal for a formal bankruptcy court for sovereign borrowers should be resurrected. Holdouts must not be permitted to block orderly restructurings that benefit debtors and creditors.

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