COMMENTARY
JULY 2014

KEY POINTS

- China prioritizes efforts to prevent sovereign debt crises, including voluntary limits on external borrowing, over initiatives to minimize the costs of sovereign debt restructuring.
- International institutional reforms on sovereign debt need to go well beyond the helpful but modest proposals in the June 2014 IMF paper on revisions to its lending framework.
- China seems open to a Sovereign Debt Restructuring Mechanism (SDRM)-like statutory platform to ensure that future debt treatments are negotiated in the context of a standstill, respect inter-creditor equity and are binding.

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CHINESE PERSPECTIVES ON SOVEREIGN DEBT RESTRUCTURING

Introduction

During the week of July 14, CIGI's Global Economy Program co-hosted a workshop with the Chinese Academy of Social Sciences in Beijing to discuss Chinese perspectives on sovereign debt restructuring. This event, which was attended by select policy makers and scholars, followed the recent IMF executive board discussion on options for reform of its lending framework.[1] At the margin of this workshop, a trio of CIGI senior fellows held additional meetings with policy makers, analysts, academics and market participants on sovereign debt issues in Beijing and Shanghai to take stock of Chinese views on next steps in the reform of sovereign debt management. In these discussions, there was clear recognition that China's increasing involvement in international capital markets as both a creditor and an issuer brings with it greater exposure to other sovereigns' debt problems and raises new issues and opportunities for China's own liability management and leadership in international financial fora.

Chinese policy makers and analysts are attempting to distill lessons and insights from the recent experience of Greece and the other European periphery countries. Their two key questions run parallel to international discussions in this space: What can sovereigns, their lenders and the international financial institutions do more effectively to prevent sovereign debt crises? And when debt crises happen, how can the costs associated with debt restructurings be minimized? Compared with the IMF's new paper,[2] which focuses on crisis resolution, Chinese analysts are more concerned with crisis prevention: they view it as the more fundamental governance issue that needs to be addressed with greater urgency.

Crisis Prevention

There is concern that both borrowers and creditors continue to be afflicted by moral hazard, which leads to over-borrowing and over-lending. On the sovereign issuers' side, the reputational costs of default and the accompanying loss of market access are insufficient to constrain over-borrowing and induce policy adjustment among serial debt restructurers. On the investors' side, principal-agent problems dampen the extent to which the threat of a haircut constrains lending. Retail investors generally do not invest directly in sovereigns and instead tend to hold their paper via managers that have an overriding incentive to search for yield. At the same time, banks and insurance companies have to hold highly rated sovereign paper under capital-adequacy standards, an imperative set to become stronger under Basel III.

Greater emphasis on crisis prevention is prioritized over refining approaches to debt restructuring. But there is clear recognition that getting agreement on preventative measures will be challenging when reform of the IMF's quotas remains stymied by the US Congress's reluctance to ratify the package agreed to by G20 leaders in 2010. That pact foresees a shift of six percent of voting rights toward dynamic and underrepresented economies such as China.

Attention was drawn to People's Bank of China Governor Zhou Xiaochuan's proposal in 2012 that countries voluntarily limit sovereign borrowing to their domestic markets.[3] Although it was acknowledged that this idea has little chance of gaining wide support, a proscription on external borrowing would prevent future crises by keeping a wider set of policy options open to sovereigns, including efforts to inflate away a debt problem. Constraining borrowing to only domestic debt would also allow future restructurings to proceed more easily: the creditor universe would be circumscribed and well known. Domestic legislation could coordinate creditors even more effectively than reformed collective action clauses (CACs). Where domestic saving is insufficient to meet borrowing needs, countries would

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commit to having their external borrowing sanctioned by the IMF or another multilateral body that would provide oversight and discipline.

Debt Restructuring and the IMF's June 2014 Proposals

While positively received, the IMF's June 2014 proposals for changes to its lending framework were seen as only a modest start on reform. The paper's first proposal — the elimination of the systemic waiver on exceptional access, as advocated by our CIGI colleague Susan Schadler a year ago[4] — is welcome. The waiver was introduced in an ad hoc manner; it was, by definition, inequitable for small countries; and it was viewed as unlikely to help limit contagion. The paper's second proposed reform — the introduction of an option to reprofile a sovereign's debt in cases where IMF staff cannot "certify" the country's solvency with high probability — is seen as marginally useful in only a small minority of cases where there is an obvious short-term bulge in debt-service obligations. Even then, it will be difficult to implement: it is still a restructuring by another name and risks transforming the already messy process of agreeing to a program and an associated debt treatment into two even messier events.

There is interest in broadening the Paris Club's membership and changing its processes to accommodate the perspectives of new creditors such as China. The Paris Club's 19 members should not continue to impose restructuring terms on other creditors based on the expectation of comparable treatment. Ratings agencies, analysts and other stakeholders should be engaged as participating observers in negotiations. But as the negotiating table expands, the tradition of operating on consensus will likely become unworkable and will need reform. Along these lines, something like a Sovereign Debt Forum, as proposed by CIGI scholars Richard Gitlin and Brett House,[5] could be a pathway to build on the Paris Club's successes while reinventing it for a new era.

The June 2014 US Supreme Court decisions on Argentina imply a need for additional reforms to make sovereign debt restructuring work smoothly. At a minimum, more effective CACs that feature single-limbed formulations with cross-issue aggregation are needed to prevent creditors from building blocking minorities in individual bond series. But even new and improved CACs will be insufficient to bind creditors into future restructurings: a statutory framework that features the possibility of standstills is required. Some participants noted that China is open to an international Chapter 9 process along the lines of the IMF's erstwhile proposal for an SDRM. An SDRM-like framework could help maintain inter-creditor equity in restructurings. In the 2012 Greek debt treatment, as some Chinese participants underscored, Greek bonds held by euro-area central banks were excluded from the restructuring, but all other central banks were subjected to the same haircut inflicted on private bondholders. This clearly violated notions of equality of treatment.

Final Remarks

China has an opportunity to burnish its international leadership by helping to build a better system for preventing sovereign debt crises and treating distressed sovereign debt. As both a creditor and an emerging issuer, China can bridge the interests of advanced and emerging economies. Looking forward, as with other economic reform programs, China is likely to take a prudent and step-by-step approach to engaging more fully on these issues.

Endnotes

1 Miranda Xafa. 2014. "The IMF's Lending Framework and Sovereign Debt Restructuring." CIGI Commentary, July 3.

2 IMF. 2014. *The Fund's Lending Framework and Sovereign Debt — Preliminary Considerations*. IMF Staff Report, May 22.

3 Zhou Xiaochuan. 2012. "Zouchu weiji jiangju xuyao sheji xinde jili jizhi." [New incentive mechanisms need to be designed to move beyond the crisis situation]. Speech made at the China Finance Forty Forum, April 28.

4 Susan Schadler. 2013. *Unsustainable Debt and the Political Economy of Lending: Constraining the IMF's Role in Sovereign Debt Crises*. CIGI Papers No. 19, October.

5 Richard Gitlin and Brett House. 2014. *A Blueprint for a Sovereign Debt Forum*. CIGI Papers No. 27, March.