

Developing countries' debt and the new international financial architecture

Tito Cordella

SAIS

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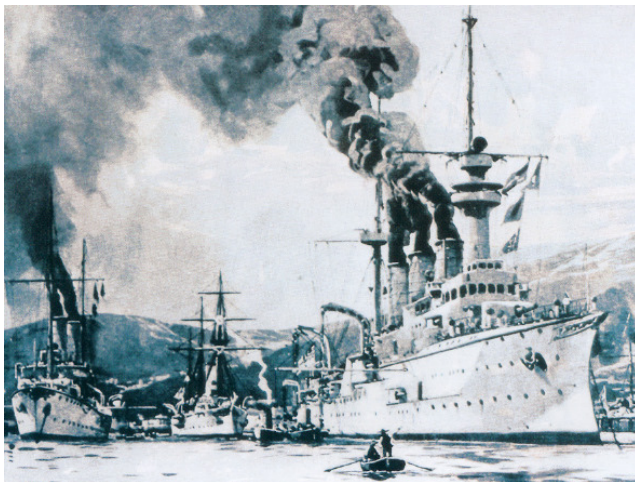
- Sovereign Debt
 - why do countries borrow and why do they (often) repay?
- The role of IFIs
 - why do they lend, and why they need “seniority”
- What IFIs should (and should not) do to protect their seniority
- The future of IFIs’ seniority in the new international financial architecture
 - where non-traditional lenders are becoming increasingly important

Sovereign borrowing

- Countries, individual, and firms borrow for similar reasons
 - smooth consumption
 - invest
 - splurge
- The main difference comes when repayments are due
 - courts may force individuals to repay
 - but it is difficult to force countries to repay

- Hobbes: “A Law is the Command of him, or them that have the Sovereign Power”
- Absolute Immunity (XIX-mid XX)
 - precluded a lawsuit against a sovereign without that sovereign's consent
 - in the sovereign's legal system or in foreign courts
 - applied to commercial transactions between foreign states and private individuals from another state
- How could sovereign debt exist under absolute immunity?

Gunboat diplomacy



- In 1898, Venezuela experienced a civil war, foreign property was destroyed and government stopped paying debt
- In 1902, Britain, Germany, and Italy blockaded the ports of La Guaira and Puerto Cabello and seized customhouses
- President Castro refused to acquiesce
- In 1903...

Germany bombarded Fort San Carlos



Venezuela, 1902-3

- In 1898, Venezuela experienced a civil war, foreign property was destroyed and government stopped paying debt
- In 1902, Britain, Germany, and Italy blockaded the ports of La Guaiara and Puerto Cabello and seized customhouses
- President Castro refused to acquiesce
- Germany bombarded Fort San Carlos
- Castro agreed to an arbitration (Feb. 03) and to a gradual liquidation of debt
- Britain, Germany, and Italy were offered a preferential payment of 30% of claims

Modern doctrine: limited immunity

- In the US, the interpretation of sovereign immunity began to change in the 1950's
 - USSR SOE operating in the US
- Foreign Sovereign Immunity Act (FSIA 1976)
 - allows private parties to sue a foreign government in US courts if the complaints relates to commercial activities.
 - other countries followed (e.g., UK, 1978)
- *Republic of Argentina v Weltover* (1992)
 - Sovereign bonds issued by a sovereign and subsequently defaulted should be considered as commercial activities under FSIA

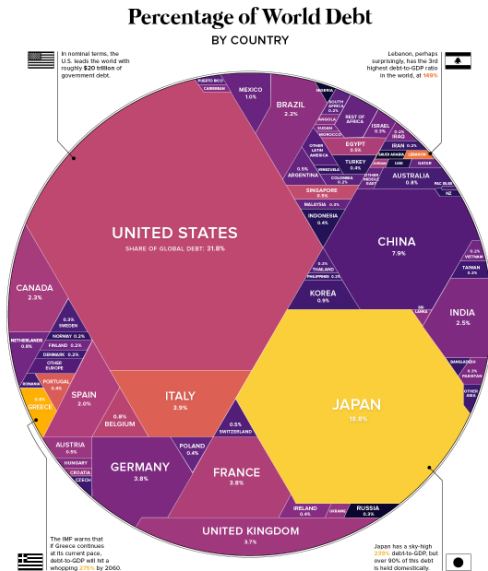
Elliott Associates v Banco de la Nación

- Elliott acquired non-performing debt guaranteed by the Peruvian government, at a large discount, prior to Peru's 1996 Brady deal
- After Peru refused to repay in full, Elliott sued in New York
- In June 2000, Elliott obtained a US\$57m. judgment against Peru
- And convinced a Brussels court to order Euroclear to suspend payments on Brady bond interest payments
- To avoid bringing the entire stock of Brady debt into default, Peru decided to settle for US\$56.3m.



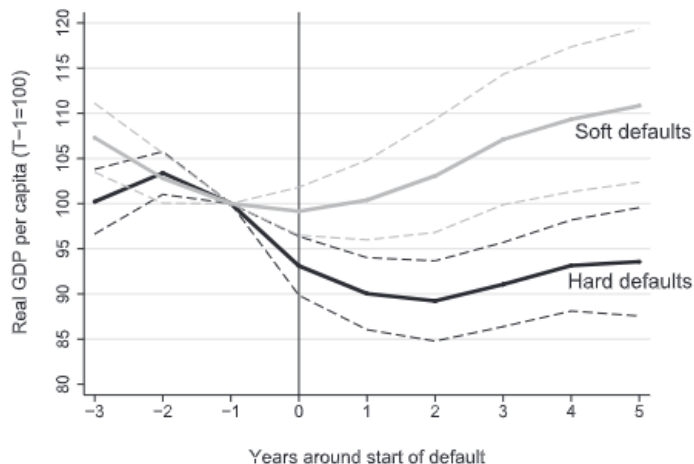
- Despite a few successful cases, the ability of creditor to seize sovereign assets is very limited
- By itself it would not sustain the existing stock of sovereign credit

World debt: about \$84 tn. in 2020



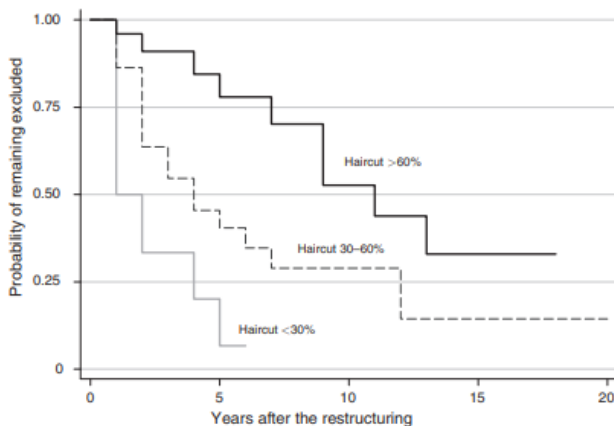
- Despite a few successful cases, the ability of creditors to seize sovereign assets is very limited
- By itself it would not sustain the existing stock of sovereign credit
- The true is that defaulting is (often) very costly
 - economic disruption
 - lack of market access
 - political turmoil

Cost of default: economic disruption



Source: Trebesh (2017)

Cost of default: lack of market access



Source: Cruces and Trebesh (2013)

Cost of default: political turmoil



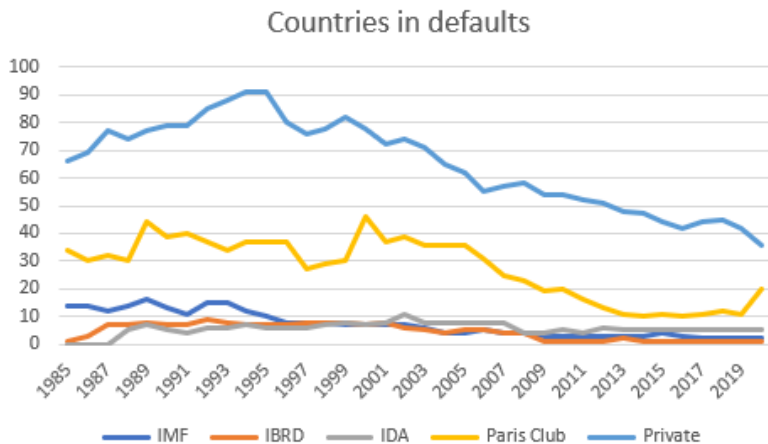
The role of IFIs

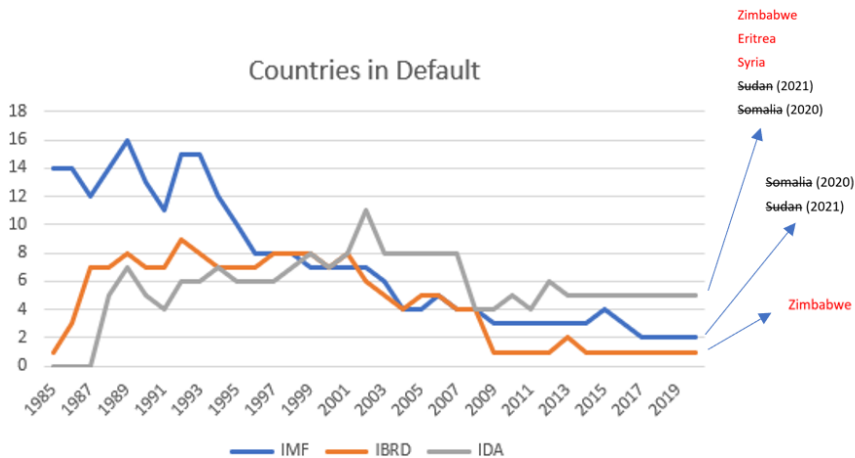
- To reduce the costs associated with financial crises (and foster poverty reduction and sustainable development)
- IFIs lend countries at below market rates (*because* they are repaid when other creditors are not)
- And lend when nobody else would (*because* they are repaid when other creditors are not)
- But there is no international bankruptcy court that can enforce IFIs' seniority
- What makes IFIs preferred creditors? And what is exactly the preferred creditor treatment they enjoy?

Preferred Creditor Treatment (PCT)

- The preferred creditor treatment **is not** a legal status or a legal obligation on governments to give the World Bank, the IMF, the RDBs, priority over other lenders
- **“It is** the practice (or custom) of borrowing member countries of continuing to service their loans from the Bank during periods when they are unable to service all their external debts in accordance with their terms, **which other creditors have acquiesced in this practice”** (The World Bank)

PCT is a common practice





What PCT entails

Variable Spread ² As of July 1, 2022												
Reference Rate	SOFR for USD, SONIA for GBP, TONA for JPY and EURIBOR for EUR (6 months interest rate period)											
Average Repayment Maturity	Up to 8 Years		Greater than 8 to 10 Years		Greater than 10 to 12 Years		Greater than 12 to 15 Years		Greater than 15 to 18 Years		Greater than 18 to 20 Years	
Currency	USD GBP JPY	EUR	USD GBP JPY	EUR	USD GBP JPY	EUR	USD GBP JPY	EUR	USD GBP JPY	EUR	USD GBP JPY	EUR
Average Funding Spread	0.49%	-0.03%	0.49%	-0.03%	0.49%	-0.03%	0.49%	-0.03%	0.49%	-0.03%	0.49%	-0.03%
Contractual Spread	0.50%		0.50%		0.50%		0.50%		0.50%		0.50%	
Standard Maturity Premium (Group C)	0		0.10%		0.30%		0.50%		0.70%		0.90%	
Adjustment to Standard Maturity Premium												
Group A (Exemption)	0		0		-0.10%		-0.20%		-0.30%		-0.40%	
Group B (Discount)	0		0		-0.05%		-0.10%		-0.15%		-0.20%	
Group D (Surcharge)	0.05%		0.05%		0.10%		0.15%		0.20%		0.25%	
Total Spread												
Group A	0.99%	0.47%	1.09%	0.57%	1.19%	0.67%	1.29%	0.77%	1.39%	0.87%	1.49%	0.97%
Group B	0.99%	0.47%	1.09%	0.57%	1.24%	0.72%	1.39%	0.87%	1.54%	1.02%	1.69%	1.17%
Group C	0.99%	0.47%	1.09%	0.57%	1.29%	0.77%	1.49%	0.97%	1.69%	1.17%	1.89%	1.37%
Group D	1.04%	0.52%	1.14%	0.62%	1.39%	0.87%	1.64%	1.12%	1.89%	1.37%	2.14%	1.62%

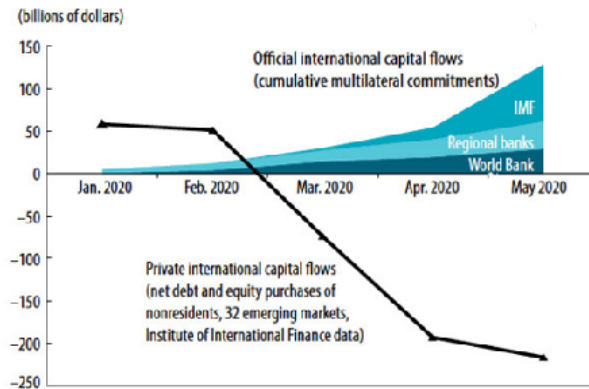
What the absence of PCT entails

Emerging Market Credit - EMBI Global Diversified

Spread (bp)



What PCT entails



Source: Horn, Sebastian, Carmen M. Reinhart, and Christian Trebesch. 2020. "Coping with Disasters: Two Centuries of International Official Lending," NBER Working Paper 27343, National Bureau of Economic Research, Cambridge, MA.

But PCT remains a sort of a puzzle

- While it is critical to IFIs' operations, it is not part of legal contracts, and is described as a market custom
- Though, until recently, no paper to provided an explanation of why this may be a (self-enforcing) equilibrium outcome
- Cordella and Powell, "Preferred and Non-preferred Creditors" (*JIE* 2021) provides
 - a theoretical justification for the existence of preferred lenders
 - and a rationale for how they may improve welfare

- IFIs enjoy PCT because they can commit to lend every country at the same (close to the risk-free) interest rate
- And they can credibly limit the amount they **collectively** lend (coordination/burden sharing)
- This is what makes lending at the risk-free interest rate sustainable and welfare improving
- Atomistic private lenders are not able to coordinate to replicate this contract (dilution)
- **Nor could competing IFIs**

- IFIs can help countries cope with major shocks, but there is a limit to the amount they can lend while maintaining PCT
 - Greece repaid private lenders while on default with the IMF, it then repaid the Fund, but...
 - Argentina received a relatively small IMF package in 2001 and repaid it in full and early, now it borrowed a lot, and...
- Asking IFIs to “share the burden” in a debt restructuring, would destroy their ability of lending risk free, and thus their value added
- But, this relies **on a common understanding** of IFIs’ seniority role
- Which is “codified” in IMF’s lending into arrears policies

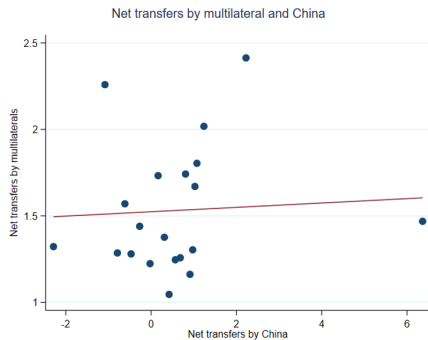
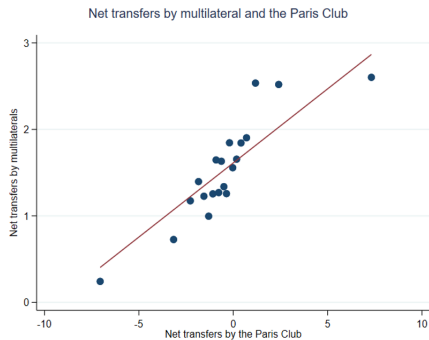
IMF LIA policy (private creditors)

- The Fund may provide financing despite sovereign arrears to private creditors if
 - (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program
 - (ii) the member is pursuing appropriate policies and it is making *a good faith effort* to reach a collaborative agreement with its private creditors

From LIA to LIOA (Sean Hagan)

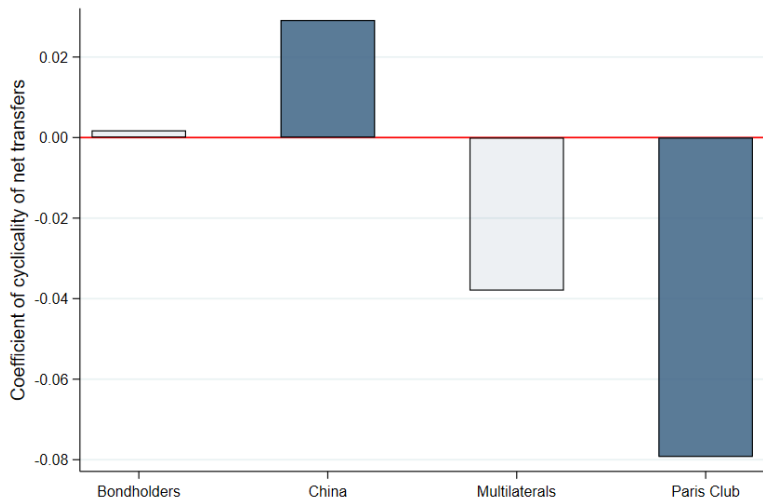
- “This muscular approach was limited to private creditors. Through the Paris Club process, bilateral government creditors continued to provide early assurances to the IMF regarding their willingness to provide the necessary debt relief on a consensual basis”
- “Over time, exclusive reliance in this consensual approach broke down with the emergence of new official bilateral creditors who were unwilling to join the Paris Club, including China”

Less cooperative



Source: Cordella and Presbitero (2022)

And less supporting in times of distress



Source: Cordella and Presbitero (2022)

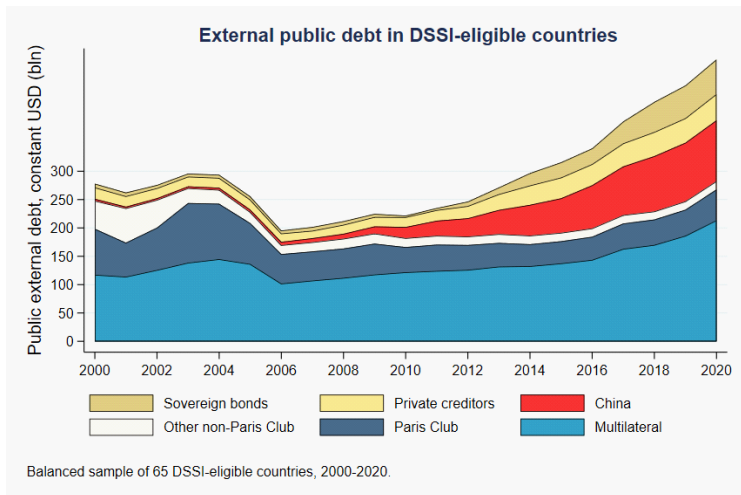
From LIA to LIOA (from Sean Hagan)

- “This muscular approach was limited to private creditors. Through the Paris Club process, bilateral government creditors continued to provide early assurances to the IMF regarding their willingness to provide the necessary debt relief on a consensual basis”
- “Over time, exclusive reliance in this consensual approach broke down with the emergence of new official bilateral creditors who were unwilling to join the Paris Club, including China”
- Faced with this challenge, the IMF decided in 2015 to adopt a policy enabling it to lend into arrears to official bilateral creditors

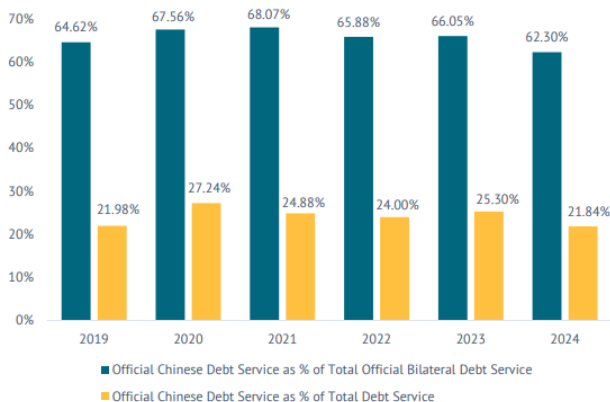
- In the absence of a representative Paris Club Agreement
 - (i) prompt financial support from the Fund is considered essential, and the member is pursuing appropriate policies
 - (ii) the debtor is making good faith efforts to reach agreement with the creditor on a contribution consistent with the parameters of the Fund-supported program
 - (iii) the decision to provide financing despite the arrears would not have an undue negative effect on the Fund's ability to mobilize official financing packages in future cases
- (iii) has been interpreted as:
 - when the total value of claims held by the official creditor(s) in question represented a “majority of total financing contributions required from official bilateral creditors over the program period”

- Where has it been applied?
 - Ukraine v Russia
 - CAR and Grenada v Libya
 - The Gambia v Venezuela

More difficult in the case of China



More difficult in the case of China



Source: Gardner et al 2020

China's market power (Gardner et al 2020)

- In Seychelles, where China's exposures were small, Beijing offered extensive debt relief, which was comparable to that provided by Paris Club creditors, as reflected in loan haircuts averaging 61%
- In the Republic of Congo, where Beijing had greater exposure and the borrower had limited leverage, China Eximbank actually increased the value of its portfolio in net present value terms by 23%

IMF strategic withdrawal?





Sergi Lanau

@SergiLanauIF

...

Debt distress lessons from the Annual Meetings: China wants to roll over and get multilaterals to restructure loans. G7 wants multilaterals untouched and traditional bilateral debt forgiveness. Hard to see how things get smoother from here. Not great for the likes of Sri Lanka.

Conclusions

- Up to 2005 international financial assistance has been mainly a G7's (family and friends) game
- Can it become a G20s' ?
 - Chiang Mai initiative, role IMF
 - DSSI
 - Common Framework
 - Zambia
 - Chad
 - Ethiopia
- Main obstacles
 - blurry line between commercial and official Chinese lending
 - overall lack of transparency
 - underrepresentation of China in BWI
 - international aid as a tool for insuring natural resources

Conclusions

- The idea that we can have **healthy** competition among IFIs (e.g., AIIB v WBG or ADB v NDB) or official lenders (e.g., Paris Club v China) is a **fallacy**
- Competition among IFIs will destroy their preferred creditor status, which is needed to fulfill their mandate
- And so will competition about official lenders
- Hence, China and the West should decide between **collaborating**, **competing**, or **splitting the world** in areas of aid influence
- Which one is more likely? You tell me!

Grazie!