Restructuring Sovereign Debts with Private Sector Creditors: Theory and Practice

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Sovereign debt is time consuming and costly to restructure. Throughout history, defaults on debt owed to private sector creditors, such as commercial banks and bondholders, have taken almost a decade, on average, to conclude. Recent research has also found that private creditors lose, on average, 40 percent of the value of their claim, and debtor countries exit default as or more highly indebted than when they entered default.

Motivated by these facts, this chapter reviews the empirical evidence on the outcomes of sovereign debt–restructuring negotiations with private sector creditors with a view to uncovering the mechanisms at work and deriving policy implications. It finds large differences in sovereign debt–restructuring outcomes across debtor countries. Debts owed by low-income countries to foreign private sector creditors, such as banks and bondholders, have been the most time consuming to restructure, taking 75 percent more time than the debts of upper-middle-income defaulting countries. Delays are particularly long in Sub-Saharan Africa. Private creditor losses from default (“haircuts”) have also been greatest on loans to low-income countries, with losses averaging more than 50 percent compared with less than 30 percent for upper-middle-income countries.

Most strikingly, and despite the larger creditor losses, low-income countries receive little debt relief from private creditors, as measured by comparing countries’ debt to GDP ratios upon completing the restructuring process with their debt to GDP ratios at the beginning of the default episode. In fact,
the average defaulting country exits default with the ratio of debt owed to 
private creditors to GDP as high, or higher, than when it entered default. 
This phenomenon is particularly pronounced for low-income countries, 
whose debt to GDP ratios rose by more than 50 percent, and Sub-Saharan 
African countries, whose indebtedness ratios more than doubled.

The chapter is organized as follows. The next section reviews recent 
empirical work on default and debt restructuring and presents new results 
on the variation in debt-restructuring outcomes across countries at differ-
et levels of development and in different regions. The following section 
reviews the recent theoretical literature on the process of restructuring 
sovereign debts to private creditors, with a view to identifying the under-
lying causes of these outcomes. It finds that a number of explanations are 
capable of explaining the lengthy delays in completing debt-restructuring 
operations, some of which also explain the size of observed haircuts. Few, 
however, have much to say about the causes of the substantial rise in 
indebtedness. The last section provides some concluding remarks.

Sovereign Debt Restructuring in Practice

This section reviews evidence on the outcomes of sovereign debt restructur-
ing with private sector creditors in practice. After describing data sources, 
the evidence on delays in restructuring, creditor haircuts, and changes in 
indebtedness are presented in turn.

Data

Attention is restricted to defaults on sovereign debts owed to private 
sector creditors, such as commercial banks and bond holders, because 
such defaults seem most difficult to resolve in practice, as measured by 
the duration of the default.1 One limitation of this restriction is that 
the interaction between the debt relief obtained from official creditors 
and relief obtained from private creditors cannot be studied. This inter-
action is frequently important, as in the case of debt relief under the 
Heavily Indebted Poor Countries (HIPC) Initiative. Eligible countries 
receive HIPC Initiative debt relief from participating official and private 
creditors. The total cost of committed debt relief under the HIPC Initiative was $58.5 billion in net present value terms ($72 billion in nominal terms) at the end of 2009. Private sector creditors provided about 
6 percent of total HIPC relief.2 Under the Multilateral Debt Relief 
Initiative (MDRI), eligible countries also receive relief from the World 
Bank, the International Monetary Fund (IMF), the African Develop-
ment Bank, and the Inter-American Development Bank. MDRI relief 
amounted to $26.6 billion in net present value terms ($45 billion in nominal terms) at the end of 2009.
Sovereign debt includes debt owed either directly by a country’s national government or indirectly by virtue of a government guarantee. The most comprehensive and widely used source of data on the dates of defaults on sovereign debt owed to private sector creditors, as well as the dates of settlements of these defaults, is published by Standard & Poor’s (S&P) (Beers and Chambers 2006). S&P defines a default on a debt contract to have occurred if a payment is not made within any grace period specified in the contract or if debts are rescheduled on terms less favorable than those specified in the original contract. S&P defines the end of a default as occurring when a settlement occurs, typically in the form of an exchange of new debt for old debt, and when it judges that “no further near-term resolution of creditors claims is likely” (Beers and Chambers 2006, p. 22). Countries often default, restructure their debts with a new debt issue, and then default again the same or the following year. S&P treats such events as part of the same default episode.

Data on private creditor losses are drawn from Benjamin and Wright (2009), who use a method based on earlier estimates by Cline (1995). In order to obtain the largest sample possible, and to ensure consistency of treatment across default episodes, they base their measures on the World Bank’s estimates of debt stock reduction, interest and principal forgiven, and debt buybacks, as published in Global Development Finance (GDF) (2009). The World Bank’s estimates of the reduction in the face value of the debt are combined with estimates of the forgiveness of arrears on interest and principal. As the World Bank data do not distinguish between forgiveness of debts by private creditors and forgiveness by official creditors, the total amount of forgiveness is scaled by estimates of the total amount of debt renegotiated and the proportion of debt owed to private creditors, using data from both the GDF and the Institute of International Finance (2001). This process is only approximate; it is possible that errors remain.

The resulting series on private creditor haircuts covers 90 defaults and renegotiations by 73 separate countries that were completed after GDF data on debt forgiveness first became available, in 1989, and that ended before 2004. The data on default dates and haircuts are combined with data on various indicators of economic activity taken from the World Bank’s World Development Indicators (2009) and GDF (2009) data on the stock of long-term sovereign debt outstanding and owed to private creditors. Short-term debt is excluded because data disaggregated by type of creditor are not available.

It is important to note that the sample may not be entirely representative. The data on haircuts, for example, were constructed from the World Bank data on debt forgiveness, which were not available for all episodes. Moreover, not all defaults began and ended within the period 1989–2004, for which these data are available. This means that the sample is both left and right censored. However, it appears that the sample contains the vast majority of all defaults on private sector debts during this period. Tomz and
Wright (2007) report that there were 121 defaults in the years after 1970 and 110 since 1980, implying that the data set used here, with its 90 defaults, covers three-quarters of the defaults that occurred. The sample does not include debt-restructuring operations that were conducted solely with official creditors under the auspices of the Paris Club or under the HIPC Initiative. Morais and Wright (2008) report 297 reschedulings of debt to official creditors and 130 of debt to private creditors in the postwar period.

Findings

This subsection presents the empirical findings. It begins by examining the observed delays in restructuring before turning to creditor haircuts and changes in indebtedness.

Delays in Restructuring. Looking across all countries in our sample of sovereign defaults on debts owed to private sector creditors, delays in restructuring averaged 7.4 years. The distribution is highly skewed, with the median default taking about six years to be resolved. These figures are slightly lower than the average duration of default recorded in a census of defaults over the past two centuries by Pitchford and Wright (2007), who report an average delay of 8.8 years; they are slightly higher than their 6.5-year estimate of delays for defaults ending after 1976. There are three instances of defaults being contiguous in time, in the sense that S&P dates a default by a country as ending in the same year or the year before another default begins. These cases seem inconsistent with the practice by S&P of merging contiguous default events. Treating these defaults as a single default episode raises the estimated delays only slightly, however, to an average of 7.6 years.

There is considerable variation in delays across groups of countries. The average low-income country experienced delays of more than nine years, while the average upper-middle-income country was able to restructure its debts in just over five and a half years (figure 12.1). Delays were longer in Sub-Saharan Africa (8.5 years) than in Latin America and the Caribbean (7.5 years) or Europe and Central Asia (4.5 years) (figure 12.2). Because the number of defaults in some regions was small, one must be careful about making generalizations, however.

Haircuts. Using the same sample of debt-restructuring episodes used in this chapter, Benjamin and Wright (2009) find that haircuts, weighted by the level of outstanding debt, averaged 38 percent. The median haircut was slightly higher, at 42 percent. There was considerable variation in the size of haircuts across countries, with some groups of private creditors not losing at all from a restructuring and others losing as much as 90 percent of the value of their claim.

There is a tendency for haircuts to decline as the income level of a country increases (see figure 12.1). Haircuts were largest in low-income
countries, where they exceeded 50 percent, on average, and lowest in upper-middle-income countries, at about 38 percent. Lower-middle-income countries were at the sample mean of 39 percent. The data also confirm the strong correlation between delays in restructuring and haircuts found in Benjamin and Wright (2009): longer defaults were associated with larger haircuts.

Somewhat less dispersion appears when the data are disaggregated by region. The largest haircuts were in Sub-Saharan Africa, where they averaged almost 50 percent; in the small sample of East Asian and Pacific defaults, haircuts were 38 percent (see figure 12.2). The average haircut across the Europe and Central Asian, Latin American and the Caribbean, and Middle East and North African regions was about 30 percent.

Indebtedness and Debt Relief. A restructuring that imposes a large haircut on private sector creditors need not result in a substantial reduction of the debt burden facing a country, at least when the debt burden is defined as the ratio of debt to GDP, as Benjamin and Wright (2009) note. Even if a country’s debt is written down, if its GDP falls by more, the debt to GDP ratio will rise. Somewhat less obviously, calculations of haircuts will reflect the time cost of waiting for the settlement, which will not be reflected in the debt to GDP ratio of the country. Finally, as the data are measured
annually, a country that issues new debt in the same year as the settlement will show a rise in indebtedness unrelated to the settlement terms received by creditors.5

Using the same sample used in this chapter, Benjamin and Wright (2009) show that although haircuts by private creditors averaged about 40 percent, the median country exited default with as much as, if not a little more than, debt owed to private creditors relative to the size of its economy when it entered default. This does not imply that the average country received no debt relief (a country may benefit from a delay in repayment). It does suggest that debt restructuring does not always successfully reduce a country’s long-term debt burden.

The results indicate that although debt to private creditors by the lowest-income countries took the longest to restructure, these private creditors also received the largest haircuts. Did these countries also receive the largest reductions in their debt burden? The data show a marked tendency for both lower- and lower-middle-income countries to exit default more highly indebted than when they entered default.

Figure 12.2 Duration of Debt-Restructuring Delays and Size of Haircuts, by Region of Debtor Country

Source: Author’s calculations.
Restructuring sovereign debts in the private sector

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Low-income countries \((n = 20)\)

Lower-middle-income countries \((n = 26)\)

Upper-middle-income countries \((n = 24)\)

1.6

1.4

1.2

1.0

0.8

0.6

0.4

0.2

0

Figure 12.3 Change in Indebtedness to Private Creditors following Debt Restructuring, by Income Level of Debtor Country

Source: Author’s calculations.

(figures 12.3 and 12.4). Among both groups of countries, the increase is substantial: debt to GDP ratios rose almost 60 percent in lower-income countries and 70 percent in lower-middle-income countries. Upper middle-income countries fared better, but even among them, debt to GDP ratios fell by less than 10 percent.

Indebtedness levels fell almost 10 percent in South Asia and 5 percent in the Middle East and North Africa; in every other region, indebtedness levels rose. The increases were especially large in Sub-Saharan Africa, where debt restructuring left countries almost twice as indebted to private sector creditors as before they entered default.

To promote a deeper perspective on these findings, this chapter examines next the evolution of indebtedness to private creditors for three Sub-Saharan African countries, chosen to illustrate key features of the data. Nigeria defaulted twice in the past 40 years. Total debt owed to private creditors increased from about 10 percent of gross national income (GNI) in 1982 at the start of Nigeria’s default to more than 30 percent by the end of the default in 1992 (figure 12.5). This increase was driven almost entirely by the increase in the “other private creditor” category, with commercial bank debt having been extinguished by the end of the default and replaced with a smaller issuance of new sovereign bonds. The focus on
debt owed to private creditors drastically understates the growth in total indebtedness, which rose from almost 15 percent of GNI in 1982 to more than 100 percent of GNI in 1992, once official debts are included. By contrast, the 2002 default was associated with small declines in all types of indebtedness.

In the Seychelles, a substantial increase in lending from other private creditors also outweighs a slight reduction in commercial bank indebtedness, resulting in an overall increase in indebtedness to private creditors (figure 12.6). The picture is magnified once official debts are included.

In both Nigeria and the Seychelles, the focus on private sector creditors tended to understate the rise in indebtedness following a settlement. In other cases, in which indebtedness to private sector creditors falls, a rise in official debts results in a different qualitative picture. Sierra Leone was in default in 1986–1995 and 1997–98. By the end of the first default, debt owed to private creditors had fallen from more than 50 percent of GNI to roughly 10 percent (figure 12.7). However, the decline was more than offset by a rise in official debt that pushed total indebtedness from 70 percent
to more than 100 percent of GNI. During the second default, by contrast, both private and official indebtedness rose, presumably because official creditors lend to low-income countries in arrears to private creditors. As such lending is much less likely in the case of middle-income countries, it may exacerbate the relative changes in indebtedness.

Theories of and Policy Lessons for Sovereign Debt Restructuring

What explains the pattern of default, settlements, creditor losses, and debt relief identified above? Are these patterns likely to persist into the future? If so, can domestic policy makers, creditor country governments, or supranational institutions do anything to implement more desirable debt-restructuring outcomes in the future?
This section reviews alternative theoretical explanations for the patterns of debt restructurings in an attempt to answer some of these questions. It begins by examining theoretical explanations for debt-restructuring outcomes, taking as given the fact that the debtor country has already defaulted. Creditors are modeled as maximizing profits; hence, the theories speak to the process of restructuring debts owed to private creditors as opposed to official debt restructuring, where considerations of equity often come into play.

Much of the early literature on bargaining over sovereign debt and debt restructuring abstracted from the possibility of delays in bargaining or found that no delays occurred in equilibrium. One of the most important early dynamic bargaining models of sovereign debt is by Bulow and Rogoff (1989), who model repeated bargaining between the debtor and a single creditor to study the constant recontracting of sovereign debt over time.

**Figure 12.6** Sovereign Indebtedness in the Seychelles, 1980–2010

![Sovereign Indebtedness in the Seychelles, 1980–2010](image)


*Note:* Shaded rectangles indicate periods in which country was in default.
in which the new contract is implemented immediately. Fernández-Arias (1991) incorporates a richer specification of the debtor economy without changing this fundamental result. Fernández and Rosenthal (1988, 1989) also model bargaining over time with feedbacks to the domestic economy, but they do not focus on cases in which negotiations span multiple periods. Aggarwal (1996) presents a suite of models, which he uses to interpret the history of sovereign default without emphasizing delay. By contrast, the focus here is on models that produce a delay in equilibrium.

Throughout, this chapter discusses those policy interventions that are likely to be most desirable. In doing so, it is important to bear in mind that there may exist a conflict between actions that reduce the costs of default today and actions designed to ensure more favorable access to credit in the future. In particular, once a country has defaulted, it is tempting to undertake actions that reduce the cost of default to that country. However, international credit markets may perceive such actions as creating an incentive
for that country, as well as other countries, to default in the future, raising the interest rates charged on sovereign borrowing. This is a classic time inconsistency problem: a country that wishes to issue debt will want to commit to measures that make the cost of default high in order to secure lower interest rates today, but it will want to undo these measures in the event that a default actually occurs. Below, a number of reforms a country can commit to in whole or in part are examined with a view to determining their possible effects on both the cost of default ex post and the welfare of debtor countries ex ante (see Dooley 2000 for a discussion).

Many of the explanations for the debt-restructuring outcomes documented above, in particular explanations for the substantial delays in concluding debt-restructuring operations, focus on the difficulties faced by creditors in coordinating to make mutually beneficial agreements with the debtor. Three such explanations are reviewed before turning to explanations that focus on the institutional environment within the defaulting country and the information and enforcement possibilities that govern sovereign borrowing in the first place.

Restructuring Negotiations with Uncoordinated Creditors

Debt is often owed to a large number of private sector creditors. In the case of the bank loans that were restructured following the 1980s debt crisis, many countries had to negotiate with dozens of banks; in the case of bond issues, it is not uncommon for bond holders to number in the thousands. Negotiating a debt restructuring is therefore difficult both mechanically (it is costly to catalogue and communicate with a dispersed group of creditors) and because of a number of collective action problems associated with debt restructuring, three of which are discussed here.

The first collective action problem, which was highlighted during the 1980s debt crisis, concerns the public good nature of debt relief. If any one bank agrees to offer debt relief by reducing its claims on a country, the value of all other banks’ claims may increase. There is a classic free-rider problem, in which some banks do not offer debt relief in the hope that they can free ride on the debt relief offered by other banks.

A variety of informal mechanisms arose to deal with this problem among private creditors, albeit imperfectly. Bank advisory committees were set up in which representatives of the major bank creditors were responsible for, among other things, convincing smaller banks to participate in the restructuring process. A number of different methods were used. Devlin (1989) argues that larger banks used their contact with these smaller banks in other markets as an inducement to participate. Milivojević (1985) suggests that such incentives work through the “network of influence” that large banks have on small banks, which includes threats to exclude free riders from future syndicates, terminate correspondent banking facilities, and cut interbank lines. In addition, in some cases debtors appear to
have discriminated against free-riding banks during a restructuring (Cline 1995; more generally, see the discussion in Lipson 1981, 1985). Sachs (1983) and Krugman (1985) present theoretical models of bank collusion to prevent free riding.

A version of this argument applies to the interaction between the debt relief offered by official creditors and that offered by private creditors. If a country owes substantial debt to official creditors, as many low-income countries do, private creditors have an incentive to delay settlement in order to free ride on debt relief provided by the official sector. In response to this concern, official debt-restructuring agreements typically contain some form of “comparability of treatment” clause designed to limit such free riding by private creditors. The application of these clauses is limited, however, by the difficulty of defining comparable treatment for private claims, which are very different from official claims (issues of coordination between private and official creditors are discussed below).

The second collective action problem concerns the role of litigious creditors engaging in holdout, which has become more important over the past few decades with the development of innovative legal strategies for encouraging repayment. Although it has been possible to bring suit against a country in default in most major creditor jurisdictions since the early 1970s, when the doctrine of sovereign immunity was weakened by, among other things, the passage of the Foreign Sovereign Immunities Act of 1976 in the United States and similar legislation in other countries, the attachment of assets remains difficult. The main difficulty lies in the fact that debtor countries typically hold few assets in creditor country jurisdictions. One asset lying within the jurisdiction of creditor countries that may be attached is the funds associated with new loans and the servicing of those loans. Some private creditors have had success pursuing court action where the disbursement of these funds has been halted by injunction. In the highly publicized case of Elliott Associates v. Peru, funds that were to have been used to pay interest on newly rescheduled debt under the Brady plan were frozen, with the result that Peru was forced to settle with Elliott Associates in full in order to avoid default on the Brady bonds (see Alfaro 2006).

The result of this and other successful legal actions against sovereigns has led to a substantial increase in such legal action, with at least 54 court cases filed by commercial creditors against highly indebted poor countries over the past decade (World Bank and IMF 2010). The fact that such holdout creditors earn very high returns (see Singh 2003) has increased the incentives to hold out from the regular restructuring process.

To see why this is the case, consider a country that has defaulted on debts that are larger than its capacity to repay. As a result, creditors as a whole must accept some reduction in the value of their claims. However, because any one creditor acting alone has the ability to hold up repayment of new debt issues using legal tactics, new creditors will be reluctant to lend to a country until every last creditor has settled. Thus, individual creditors
have an incentive to delay agreeing to any restructuring proposal involving a reduction in the value of their claim in the hope that other creditors will agree first and allow the holdouts to extract full repayment later on. Pitchford and Wright (2007, 2009) have constructed models of this phenomenon that show that such incentives are strong enough to explain the substantial delays in restructuring that are observed in practice.

A number of policy proposals have been advanced to deal with this problem. Early proposals included the reintroduction of bondholder councils (Eichengreen and Portes 1989, 1995; Eichengreen 2002) and the introduction of a supranational bankruptcy court (Krueger 2001, 2002a, 2002b). Most notable has been the introduction of collective action clauses into bond contracts that allow a supermajority of bondholders to impose common restructuring terms on minority holdouts (see Taylor 2002). Collective action clauses have now become standard in bonds issued under New York law. Pitchford and Wright (2007) examine the likely effect of such clauses within the context of their calibrated model. They find that such clauses will likely reduce, although not eliminate, delays in restructuring. They also show that although collective action clauses will increase the incentive for debtor countries to default, the cost of borrowing by these countries will likely not increase, because the increased default risk is offset by larger and more timely settlement payments.

A third collective action problem—the potential for free riding on negotiation costs—is at the heart of why Pitchford and Wright (2009) find that collective action clauses are likely to reduce but not eliminate delay. When collective action clauses are used to impose common settlement terms on bondholders, they reduce the latitude of discriminatory settlements being used to compensate those bondholders who take the lead in negotiations and bear the brunt of these costs. Pitchford and Wright (2009) provide evidence that these costs are very large (more than 3 percent of the value of a restructuring in some complicated cases) and often hard to verify and thus difficult to compensate directly through reimbursement of expenses. Collective action clauses may thus remove the ability of bondholders to hold out for full repayment but exacerbate the incentive for bondholders to free ride on negotiation costs.

A number of policy options are available to debtor and creditor governments and to supranational institutions to deal with collective action problems. From the perspective of debtor governments, the results of Pitchford and Wright (2007) suggest that by issuing debt that is easier to restructure, sovereigns may actually reduce the cost of their borrowing. Policy innovations aimed at easing restructuring may be extended beyond the introduction of collective action clauses—which are now widespread—to include arbitration procedures and perhaps even the most favored creditor clauses discussed, but not fully implemented, in the restructuring of Argentina’s debt in 2004. From the perspective of creditor country governments, there are now international agreements designed to
ensure that creditors do not sell their own claims on defaulted countries to litigating creditors, a practice that occurred in Paris Club and European Union countries in 2007 and 2008 (World Bank and IMF 2010). For supranationals, the Debt Reduction Facility (DRF) of the World Bank’s International Development Association (IDA) can be used to buy back debt from private creditors at a steep discount. In at least one case, it has been used to buy back the claims of litigating creditors, a procedure that could be expanded. However, it is important that these funds be used to settle with all litigating creditors and to extract concessions from these creditors, in order to avoid problems like those associated with the 1988 Bolivian buyback (see Bulow and Rogoff 1988 for a discussion).

To what extent can any of these theories explain the patterns in debt-restructuring outcomes across countries described above? It is not implausible to think that some of these collective action problems are most severe for low-income countries. For example, the costs of bargaining with low-income countries may be higher than those associated with middle-income countries because of imperfect public debt management systems and records of debt holdings. In addition, if low-income countries suffer from a more severe debt overhang problem than higher-income countries, concessions by fewer creditors (in particular official creditors) will substantially increase the value of outstanding private debts, magnifying the free-rider problem of private creditors. Middle-income countries tend to have a larger number of debts and a larger proportion issued as bonds, which are often widely held. Whether these conjectures have merit and are quantitatively significant in explaining outcomes is a topic for future research.

**Restructuring Negotiations with an Uncoordinated Debtor**

The above explanations assume that the debtor country can be regarded as a single decision maker—that is, that agents within the country coordinate perfectly. In practice, some of the delay in restructuring may reflect conflicting agendas within the debtor country. In particular, if the costs of a restructuring cannot be shared equally by all groups within a country, there may be delay as different groups hold out for a smaller share of the costs. It is precisely this intuition that underlies Alesina and Drazen’s (1991) model of delays in the adoption of a stabilization policy. Their idea is most easily presented by an example.

Consider a country in default that is made up of two provinces. As long as a restructuring deal is not reached, government spending is reduced, and both provinces lose, as a result of higher taxes and reductions in investments in infrastructure. A debt restructuring requires that the country further reduce spending, increase taxation, or both, in order to generate a fiscal surplus with which to repay creditors. For simplicity, suppose that the fiscal surplus can be generated only by reducing transfers to one or both of the provinces and that there is no way to force an equal reduction
on both provinces. In such a world, the residents and representatives of both provinces have an incentive to incur short-term costs with the aim of forcing the other province to accept the greater reduction in provincial transfers. In particular, each province has an incentive to delay agreeing to a restructuring in the hope that the other province concedes first and accepts the larger share of the reduction in transfers.

Competition between different groups in a society as to who should bear the greater cost of reform is common. If this phenomenon is more severe in low-income countries, it might explain the heterogeneity in outcomes documented above. In theory, the solution to such a situation is adoption of an institutional structure that allows for the equitable imposition of the costs of reform on all competing parties. In practice, doing so may be difficult: in the example discussed above, the size of transfers to the provinces may be constrained in the constitution of the country and therefore be difficult or impossible to change without the agreement of both provinces. In such a case, there may be a role for creditor country governments and supranational institutions to encourage domestic stakeholders to engage in reform discussions and to reward cooperation with the transfer of new funds (a bailout) or greater debt forgiveness.

**Delays with Coordinated Debtors and Creditors**

Delays can occur in debt restructurings for many other reasons. The need to compile and consolidate a list of the outstanding claims affected by the default may cause delays (this is often true in cases in which the debts of private sector agents within the debtor country are assumed by the government during a default, as was the case in Républica Bolivariana de Venezuela in the mid-1980s, as described in Holley 1987). Alternatively, both debtors and creditors might agree to delay restructuring debts if the cost of doing so is expected to fall in the future, perhaps because the effects of an adverse shock are expected to dissipate (see, for example, Bi 2008; Dhillon and others 2006; Merlo and Wilson 1995). This section examines two other explanations for delays in bargaining that abstract from collective action problems, emphasizing aspects of the information and enforcement environment surrounding sovereign borrowing.

One of the most popular approaches to explaining delays in bargaining across a wide variety of situations is to assume that there is an asymmetry of information between the parties to bargaining. In the case of negotiations to restructure sovereign debts, a debtor country likely has more precise information about the political and economic costs it would face by agreeing to a settlement than does the creditor. For its part, the creditor is likely to have more information about the state of its balance sheet and the set of alternative investment opportunities it faces. In such a world, neither party knows the value the other party places on agreeing to a settlement.
A number of formulations of bargaining in the presence of so-called “two-sided asymmetric information” have been presented. Cramton (1984) studies a two-sided asymmetric information version of Admati and Perry’s (1987) bargaining environment in which the time between offers is chosen endogenously by the bargaining parties. In such a world, delay—which is implemented by making nonserious offers that are rejected—serves to reveal information about the value each player places on a settlement, with each party becoming more pessimistic about the other party’s valuation as time goes on. Delay is informative, because the more the player values agreement, the more costly is delay. When offers are eventually made in such a world, the valuations of both creditor and debtor are revealed. Delay is socially inefficient, which begs the question of whether there may be other, less costly means of revealing a player’s type. In a related context, Horner and Sahuguet (forthcoming) show that the ability to signal one’s type by committing resources (other than through the time cost of delay) acts to essentially eliminate delay. One implication for policy makers is that they should investigate mechanisms that allow for faster, less socially costly means of revealing information.

An alternative explanation for delays in debt restructuring is based on the limited enforceability of contracts. In particular, if agreement to a restructuring produces benefits for the country both at the time of settlement and in the future, possibly as the result of better capital market access, creditors will bargain over a share of these future benefits. If agents are patient, these future gains are likely to far exceed current gains; the only way for the debtor to share these gains with the creditor will be to issue debt. However, such debt may not be very valuable if the creditor perceives that the debtor will likely default on it. Thus, it may be optimal to wait until future default risk is low before agreeing to a debt restructuring.

Benjamin and Wright (2009) formalize this intuition, showing that this mechanism is further strengthened by the fact that reaccess to international credit markets is more valuable to the country when future default risk is low (because the country can borrow on better terms), giving the parties another reason to delay. Thus, sovereign debt–restructuring outcomes are driven by the determinants of future default risk, including the evolution of the sovereign’s economy, the evolving political trade-offs within the economy, and the evolving institutions governing debt restructuring that affect the relative bargaining powers of the parties. Benjamin and Wright place particular emphasis on the development of official lending into private arrears as reducing creditor bargaining power and prolonging the 1980s debt crisis.

They show that a calibrated version of their model can explain the fact that the level of indebtedness to private creditors typically does not decline following a settlement. They are unable to explain the large
increases in indebtedness to private creditors observed following debt-restructuring operations involving the lowest-income countries, including those in Sub-Saharan Africa. Their model is capable of explaining the longer delays and larger haircuts for the private creditors of low-income nations if there is more persistence in output fluctuations or debtor bargaining power among such countries. This seems plausible, to the extent that greater official lending to low-income countries implies a larger role for official lending into arrears in influencing private creditor bargaining power.

What are the implications for policy makers? Benjamin and Wright (2009) emphasize the role of bailouts as both a cause of and solution to these delays. They show that bailouts in which supranational governments transfer resources to a country conditional on reaching a settlement can reduce delays in bargaining, albeit at the cost of making it more tempting to default, which reduces country welfare overall. They argue that uncertainty over both the likelihood and the size of a future bailout can increase delays, underlining the importance of having a transparent and timely process for providing these funds.

Enhanced coordination between the official and private sectors aimed at preserving the bargaining position of private creditors could also be effective. One possibility would be for the World Bank, the IMF, and creditor country governments to tie their own debt relief to the requirement that the sovereign bargain with private creditors in good faith. In return, private creditors might be expected to commit to accepting a standardized haircut and to lending appropriately in the first place (by, for example, observing the Equator Principles on project financing and lending only to countries with low risk of debt distress).

Concluding Remarks

Restructuring sovereign debt is very time consuming. It is also ineffective at preserving the value of private creditors’ claims or reducing the level of indebtedness to private creditors of defaulting countries. This chapter presents evidence that these problems are particularly severe among the low-income countries of Sub-Saharan Africa, where delays are longest, private creditor haircuts are largest, and indebtedness to private creditors rises most following debt restructuring.

Theoretical research has uncovered numerous explanations for why negotiations to structure debts might be inefficient and time consuming, several of which appear capable of explaining the size of private creditor losses. Much less work has been devoted to understanding the causes of the dramatic rises in indebtedness to private creditors experienced by low-income countries following a default. This is surely a priority for future research.
Notes

The author thanks, without implicating, Stephanie Huynh for outstanding research assistance, Dörte Dömeland, Brian Pinto, Federico Gil Sander, Gallina A. Vincelette, two anonymous referees, numerous conference participants, and, especially, Mike Tomz, for comments.

1. With regard to the restructuring of debts owed to official creditors, one typically observes only the date at which an agreement is reached with the country, not the date when negotiations began. Anecdotal evidence suggests that such deals are usually concluded quickly, however.

2. Most multilateral financial institutions and Paris Club bilateral creditors have provided debt relief under the HIPC Initiative. Delivery of HIPC Initiative relief from private creditors is a key challenge to the implementation of the initiative. For more information, see World Bank and IMF (2010).

3. Three instances of defaults are contiguous in time. This finding seems inconsistent with S&P’s practice of merging contiguous default events. Treating these defaults as a single default episode increases the average delay only slightly, to 7.6 years.

4. Data on the high-income subgroup were dropped because the group contained only two defaults.

5. Broader measures of debt, including official debt, may also increase as the debtor substitutes different forms of finance.

6. In principle, most favored creditor (MFC) clauses would allow creditors participating in an initial exchange offer to exchange their new claims under the terms of any subsequent exchange offer or settlement. The final draft of Argentina’s MFC clause removed the ability of such creditors to participate in future “settlements.” See Gelpen (2005) for a discussion.

7. The boards of the International Bank for Reconstruction and Development (IBRD) and IDA established the World Bank’s Debt Reduction Facility for IDA-Only Countries (DRF) in 1989. The DRF helps extinguish commercial debts through buybacks at a deep discount. Its objective is to help reforming highly indebted poor countries reduce their commercial external debt as part of a comprehensive debt resolution program. As of September 2010, the DRF had supported 25 buybacks in 22 countries, extinguishing about $10.2 billion of external commercial debt.

8. For more on the effect of asymmetric information and reputation on the development of sovereign debt markets, see Tomz (2007).

9. I thank Frederico Gil Sander for these suggestions.

References


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