



GOVERNMENT DEBT IN ROUGH WATERS

A Navigation Guide
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Abstract

The COVID-19 pandemic is pushing public debt to unprecedented levels, increasing the incidence of sovereign debt distress. How governments learn to live with such debt levels or find orderly — or less orderly — ways to reduce them will shape the future of our societies. Lazard offers ways to improve outcomes for governments facing a debt reckoning.

The COVID-19 pandemic is triggering sovereign debt distress across the globe. Public debt was already elevated in many countries before the crisis hit, and the pandemic has created a surge of debt without precedent, even during wartime. How governments learn to live with such debt levels or find orderly — or less orderly — ways to reduce them will have a critical impact on people's lives across the world.

Lazard's Sovereign Advisory Group, part of its Financial Advisory business, has been advising governments on complex financial matters for a century. This note draws from the Group's experiences in highlighting several key observations on rising debt levels, including specific recommendations on how to improve outcomes for governments:

- *The wide variation in public debt levels across countries and differences in their capacity for bearing this debt: countries are unequal before debt;*
- *The complex policy trade-offs faced by governments at risk of financial distress;*
- *How an evolving creditor universe is changing the dynamics of debt restructuring; and*
- *How the process of debt restructuring could be made to function more smoothly.*

Uncharted territory

Public debt levels have reached unprecedented levels, and the trend is upward.

The Great Financial Crisis led many governments in *Advanced Economies* (AEs) to avoid economic collapse by increasing public debt to offset retrenchment in private sector balance sheets. Assisting the financial sector only increased the bill.

As a result, public debt expanded considerably, testing multi-century historical ranges. The average gross debt-to-GDP ratio in AEs peaked in 2012 at 107% according to IMF data, from 72% in 2007¹. Even after the worst of the Great Financial Crisis had passed, governments acted slowly in bringing public debt down, perhaps as a consequence of fiscal adjustment fatigue and the anesthetic effect of near-zero interest-rate policies². Only a few governments such as Germany were able to reduce debt substantially, and the AEs' average debt level remained as high as 105% of GDP at the end of 2019.

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The COVID-19 crisis, therefore, hit public finances in the advanced world while the healing process from the Great Financial Crisis was far from complete — and, by some measures, had barely started. Consequently, the total public debt of this category of countries is expected by the IMF to reach 131% of GDP at the end of 2020, or more than USD 60 trillion.

At the same time, gross debt rose at a slower pace and from a lower starting point in *Emerging Market Economies* (EMs), with debt in these economies increasing from 38% to 53% of GDP between 2007 and 2019. These countries, subject to sporadic bouts of financial stress, had been wary of over-borrowing, even if they had succeeded in freeing themselves from the

¹ IMF Fiscal Monitor, April 2020

² This anesthetic effect has been conceptualized by O. Blanchard in 'Public debt and low interest rates' (American Economic Review 2019) : 'If the interest rate paid by the government is less than the growth rate, then the intertemporal budget constraint facing the government no longer binds'.

obligation to borrow exclusively in dollars (the "original sin"³) and were able to raise debts from international investors in their own currency. It is unclear whether this denomination shift has reduced possible contagion effects, in which a debt problem in one country spreads to others, but exchange rate risk is now arguably borne by investors.

In *Developing Economies* (DEs)⁴, public debt rose as well (from 32% to 43% of GDP on average over the same period), in some cases from a low starting point as a result of the debt cancellation initiatives of the previous decade (i.e., HIPC). Low global interest rates and the emergence of China as an economic superpower brought about two major changes over the last 15 years for DEs: (1) international capital market access started to open up for frontier issuers and single-B rated economies, and (2) China's bilateral lending, through different forms, became a driving and sometimes contentious source of funding, notably in Africa.

Unequal before debt

While public debt quanta have risen sharply across countries, the capacity to live with such debt varies considerably from country to country.

It is striking how differently countries and governments can experience the same (high) level of debt: some barely notice it, expand fiscal stimulus packages and accumulate deficits after deficits; others seem intolerant to it and reach out to their creditors to procure relief.

One reason is that the usual metric, the gross debt-to-GDP ratio, has limited analytical value in and of itself. Some countries have trouble with debt of 40% of GDP, while others seem hardly affected by a ratio as high as 216% (as was Japan's in 2019). Debt-to-GDP levels are in fact not well correlated with default risk. Indeed, from 1998 to 2020, sovereign defaults occurred with governments' debt-to-GDP reaching 85.1% on average one year before default, but with a standard deviation of 42% (for a min of 28.1% and a max of 178.4%). In fact, since 2010, defaults have on average occurred at higher debt-to-GDP levels than previously (98.1% versus 71.4%), perhaps as a consequence of lower interest rates, which make debt more bearable. The standard deviation over this period remains high (44%).

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In debt crises, governments are faced with liquidity and/or solvency problems that are notoriously difficult to disentangle. What is the tipping point when a government's debt cannot (and perhaps should not) be repaid according to its contractual terms? There are three practical, inter-related questions to be answered: Can the debt be refinanced? Is it affordable? Is it sustainable?

³ The expression 'original sin', coined by Barry Eichengreen, Ricardo Hausmann, and Ugo Panizza, described the traditional difficulty (or impossibility) for non-advanced economies to borrow in their own currency, thereby exposing themselves to exchange rate risk.

⁴ To use the IMF World Economic Outlook terminology. Developing economies are typically less integrated in the global financial system.

Can the debt be refinanced at less-than-exorbitant prices?

The first question is one of liquidity risk, a function of the size of the gross financing needs (the supply side) and of the depth and risk aversion of the investor base (the demand side).

Emerging market governments primarily fund themselves via capital markets, though they do not benefit from a large and reliable investor base and are directly or indirectly dollar dependent. As a result, they are vulnerable to liquidity risk, notably in a "risk-off" market context.

Liquidity risk is a fickle concept, and clearly countries experience it to different degrees. The U.S. Treasury, for instance, plans to issue nearly USD 5.5 trillion of debt this year, close to 25% of U.S. GDP, but is expected to print at historically low interest rates regardless. This result for the U.S. is not surprising, since countries whose central bank issues a reserve currency have a considerable edge: liquidity risk is low in countries where the central bank (including the Fed, the ECB, the Bank of Japan, and the Bank of England) can deploy its balance sheet and purchase government paper without endangering its credibility.

Recently, some EMs' central banks (such as South Africa, Colombia, and Poland) have announced modest government debt purchasing programs without triggering a currency crisis. This is a notable development, though it is too early to declare that these countries are immunized against liquidity risk.

An intermediate solution to liquidity risk is to borrow the credibility of a reserve-issuing central bank or at least a central bank with considerable FX reserves (e.g. China). To this end, the U.S. Fed has extended several USD 60bn swap lines in dollars with four emerging market central banks (Brazil, Mexico, Korea, and Singapore); the ECB has put in place liquidity arrangements in the form of swap lines for nine countries (including Croatia and Bulgaria) and repo lines with four others (Romania, Hungary, Albania, and Serbia); and the People's Bank of China has extended swap lines with Argentina and Egypt.

Overall, on the liquidity spectrum, the least vulnerable countries are those whose central bank issues a reserve currency; followed by those whose central bank can purchase in the market significant amounts of government paper without losing credibility; followed by those that have a swap line with the Fed; followed by all the rest, of which many have turned to Lazard for financial advice.

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There is inevitably a point where the interests of the creditors and the public collide. Creditors want to be repaid according to the contract. The public wants public pensions to be honored, roads and bridges to be safe, children to be educated, and healthcare to be provided (especially during the current pandemic).

Is the debt affordable?

The next question is how easily the country and its government can live with debt. There is inevitably a point where the interests of the creditors and the public collide. Creditors want to be repaid according to the contract. The public wants public pensions to be honored, roads and bridges to be safe, children to be educated, and healthcare to be provided (especially during the current pandemic).

There is no universal limit to how much public revenues could go to paying interest to creditors, and some countries have higher tolerance for this type of commitment than others. A simple rule of thumb, however, is that when interest payments consume more than a fifth or so of budget revenues, the tension becomes palpable. An example is Lebanon at the end of 2019, which faced interest payments in excess of 50% of total public revenues — though the interest bill was in large part recycled throughout the economy because the debt is mostly domestically owned. Sri Lanka and Egypt have elevated interest bills as well.

Some countries that borrow in dollars and whose public revenues are indexed on commodity prices (such as Nigeria, Angola, and Zambia) are particularly exposed to sharp deviations in the interest bill burden. They are hit on both sides when currency depreciation inflates the interest bill while, at the same time, government revenues fall sharply.

Is the debt sustainable?

The final question is the trajectory of the debt, and whether it is under control. As all economics students learn, this is a function of the interest rate, the growth rate and the primary budget balance (that is, the budget balance excluding interest payments). The intellectual framework underpinning Argentina's current debt restructuring is about such sustainability and the problem of elevated interest rates in a context of moderate growth prospects.

According to IMF figures, the average debt ratio for emerging countries will rise by about 14 percentage points in only two years (2020-2021) and eight countries will reach debt levels above 80%, a critical threshold used by the IMF in its sustainability assessment. Lower GDP growth and higher risk premia require higher primary surpluses to stabilize the debt, which then conflicts with the affordability constraint: there are limits to slashing spending or raising revenues.

Getting it right

Rising debt burdens confront governments with unpalatable choices, especially as debt distress tends to occur at higher debt levels.

There are typically five ways to deal with public debt: grow out of it, repay it through fiscal adjustment, inflate it away, evade it through financial repression, or restructure it.

For any government, there are hardly more complicated questions than finding the right response. The future of the country is often at stake. In Lazard's experience, "getting it right"

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means methodically rank ordering the different policy choices and ensuring smooth execution once a decision has been made.

Faced with a situation of debt distress, a government needs to balance the expected short-term relief of some form of debt restructuring with the possible long-term detriment of higher future financing costs. Put another way, it takes considerably more time to climb up the credit rating scale than to go down it.

Recent initiatives in support of low-income countries shed some light on such a trade-off. Many of the poorest countries (known as International Development Agency-eligible countries) are eager to receive some short-term commercial debt relief, in addition to those offered by bilateral creditors via the G20 Debt Service Suspension Initiative (DSSI).

But they also know that not repaying market debt will trigger a default, precipitous downgrades, possibly a banking-sector crisis and a long period of high funding costs. This can perhaps ruin a decade or more of patient investor relations. For African countries in particular, this is a critical juncture as the continent is faced with the refinancing of the Eurobond debt accumulated during its first cycle of market access that started ten years ago. A failure by many African issuers to repay market debts on time would be perceived by investors as a sign of specific regional debt intolerance and create a stigma for any borrower in the continent for many years, just as investment needs are considerable.

The new negotiation landscape

Just as debt quanta have increased, the types of creditors have expanded, creating new — and, at times, intractable — challenges.

For each dollar of sovereign debt there is one dollar of assets on the books of a fund manager, a bank, a multilateral institution, another government or, increasingly, on the central bank's balance sheet.

It is important to understand the dynamics of the negotiation with each of these different creditors. Lazard, having been on the battlefield for a long time, has observed some notable changes in the recent decade.

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International Financial Institutions: judges and parties?

International Financial Institutions (or IFIs, such as the World Bank, IMF, and regional development banks) often lend in last resort and, partly as a result, enjoy preferred creditor status. Multilateral debt, around USD 400bn for the World Bank and 138bn for the IMF, is therefore "untouchable," even when an IFI (the IMF) is the largest creditor, such as in Argentina currently. In practice, IFIs play their share in the resolution of liquidity/solvency crises by disbursing new financings at generally low cost. This helps refinance the repayments due to them.

There are currently two contentious policy issues with this framework, however. First, IFIs are understandably reluctant to *de facto* finance the repayment of private external debts. That said, requesting as a condition of intervention some sort of private sector standstill would be

self-defeating: this would likely prevent IFIs from performing their proverbial "catalytic" role if the standstill triggered events of default and rating downgrades. Second, the rather elevated cost of IFIs' facilities in some cases, especially the IMF Extended Fund Facility, seems at odds with its senior creditor position, generating tensions with bondholders in restructuring situations.

Bilateral creditors: a united front?

Over more than sixty years, the Paris Club, a group of large creditor nations, has devised a set of rules in close coordination with the IMF to provide coordinated and tailored solutions to over-indebted nations. The Paris Club proved an efficient forum to implement debt cancellation initiatives in favor of the poorest countries (HIPC) and deal with complex debt situations, even in cases like Iraq (2004) with high geopolitical stakes.

A key issue today is that existing Paris Club lenders are no longer the largest players. The largest single bilateral creditor to developing and emerging countries, China, is not a full-fledged Paris Club member, nor is India. Bilateral debt with China was estimated⁵ at nearly USD 350bn in 2017, as compared with 317bn for the Paris Club at the end of 2019. The dialog among bilateral lenders has improved over the years, but the new lenders' willingness to adhere to the "rich" club's rules, designed by others, remains to be tested each time a debtor country needs assistance from both the IMF and its large emerging creditors. Positive signals emerged recently on this front. For the first time, in the case of the Republic of Congo in 2019, China demonstrated its ability to coordinate with the IMF and other bilateral lenders in an IMF-led bailout. The Congo deal may offer a template to similar situations currently arising, such as in Zambia, Angola, and Sri Lanka.

Note that Chinese lending abroad does not only take the form of bilateral loans. Project-related financing disbursed by large Chinese companies operating abroad and backed by Chinese banks can represent meaningful amounts in some countries, notably in Africa. In the case of Congo, the Chinese authorities played a constructive role in agreeing to exclude these loans from the treatment of bilateral debts and to implement the terms agreed with commercial creditors.

Secured or unsecured lending

Commodity traders and commodity-backed lending also play a greater role, raising new issues in terms of comparability of treatment with other creditors. By design, collateralized lending offers better chances of repayment. It is then harder to convince collateralized creditors to agree on meaningful debt reduction – all the more so because this may unravel their business model if/as their funding cost increases as a result.

Chad succeeded in 2017 in obtaining debt relief from one large oil trader in the context of an IMF-led bailout, but the deal did not require a notional haircut of the debt. The situation is different in the Republic of Congo: discussions are still ongoing to find an agreement compatible with the commitments it has taken with the IMF in terms of debt treatment, in the context of its IMF-supported program. The IMF expressed its concerns about the increasing share of collateralized lending in total public indebtedness in a recent report, and the more traditional private creditors (through the IIF) have initiated discussions with commodity traders to find ways to convince them to play a more constructive role.

⁵ 'China's overseas lending' (April 2020), Kiel working paper, by S. Horn, C. Reinhart and C. Trebesh.

Domestic banks and feedback loops

The "old days" of Latin American debt restructuring involved big U.S. banks (Citicorp, Chase Manhattan, JP Morgan, Bank of America, and Bankers Trust) and a debtor government, with the IMF as an influential referee. Extracting haircuts from these banks was difficult — the exposure of the nine largest U.S. banks to Latin American sovereigns represented 175% of their capital in 1982 — but critically the outcome was a net improvement in the balance sheet of the indebted government. For the country, there was no macroeconomic consequence associated with the loss absorption process at the bank level.

This contrasts considerably with situations where the creditor banks are *local* banks. Government paper, rightly or wrongly, is almost always deemed a risk-free asset, requiring no capital. As a result, and certainly in those countries where banks made good money raising cheap deposits to acquire well remunerated zero-risk-weighted government paper, debt restructuring is a headache.

Debt owned by the local banking system, either in local or in foreign currency, is harder to restructure unless there is an easy way to recapitalize banks without relying on the government. In Greece, the large holdings of government bonds by local banks risked creating a negative feedback loop between the banks and the sovereign that complicated the resolution of the crisis. This explains, in part, why the sovereign remained highly indebted towards its European partners: after the restructuring, it had to borrow large amounts to recreate a capital base in the banking sector. It also explains why Cyprus, a year later in 2013, decided to bail-in its banks. Lebanon is currently faced with the same acute challenge.

Although not a source of any imminent vulnerability, the COVID crisis has triggered an increase in the holding of national public debt by Euro area banking systems. For instance, at the end of July, French banks held EUR 419bn of French government debt, representing 90% of their capital; Italian banks held EUR 709bn of Italian government debt, representing 346% of their capital; and Spanish banks held EUR 278bn, representing 119% of their capital. Reducing the exposure of the banks to their sovereign was a key objective of the "banking union" process initiated in 2012 in the euro area, but it remains difficult to achieve.

The bondholders: between fiduciary responsibility and social responsibility

Today, bondholders play a dominant role in sovereign debt financing, certainly for AEs and EMs, and their role and influence is itself changing. The size of the emerging market sovereign bond market was close to USD 12 trillion at the end of 2018, with roughly 10% in foreign currency and 90% in local currency.

Bondholders are overwhelmingly constituted of fund managers that invest others' savings without the use of leverage: pension funds, insurance companies, central banks, and Sovereign Wealth Funds. Contrary to banks, which are "principals" in a debt restructuring (i.e., their balance sheet is at risk), fund managers are "agents." They negotiate on behalf of their own clients who will ultimately pay the price of any (required) concession.

Also, fund managers' money could be invested either deliberately (alpha-seeking strategies) or, as has become more common, passively (index-tracking). The combined rise of emerging market investing and of passive investing has changed the investor base of many countries. The traditional emerging market expert funds have been joined by the large universal and often passive funds such as BlackRock, Fidelity, State Street, and Vanguard. It is too early to

know if passive money is more or less amenable than active money to accord with borrowers in case of financial distress.

Latin American debt restructurings in the 1980s were thought to be simplified by the limited number of actors — the large U.S. banks notably — and the role of the U.S. Treasury. As a result, the view, a decade ago, was that the replacement of bank debt by bond debt would make restructurings much more complicated as a result of the atomization of creditors. In that respect, the case of Ukraine in 2015, where one single institutional investor could hold a large share of total debt and play a systemic role in the resolution of the crisis looked somewhat like an anomaly. In fact, the fund management industry has gone through its own concentration trend and, combined with the increased popularity of emerging market investing, large fund managers now dominate the field. In the most recent restructurings of sovereign debt, the largest fund managers have all been at the negotiation table. As a result, a more institutionalized group of the largest fund managers could be a decisive stakeholder in the near future — if fund managers wish to collectively engage in such a way.

Although it is a delicate position to be in given their fiduciary responsibilities, many of these large funds are aware of their role in terms of both responsible and sustainable investment. How large funds navigate the trade-off between fiduciary responsibility and sustainable investing will influence the outcome of future government debt restructurings.

Central banks and the elusive frontier between debt and money

Bond buying by central banks in the context of QE operations provides an efficient shield for governments against volatility in the sovereign debt market. That said, the large and still rising share of central banks' holdings in sovereign debt raises new challenges⁶.

Ultimately, the outcome of advanced economies' unprecedented public debt accumulation hinges on how long their central banks can *credibly* ascertain that ongoing public debt purchases are indispensable to avoid deflation. Rising inflation, however unlikely, would confront these economies with intractable financial challenges and possibly put to test the global monetary architecture of the last half-century.

Should government debt reach the tipping point of unbearability, what would happen to the central bank as a major holder of government's debt? This question is not theoretical. In Greece, the Eurosystem obtained favored creditor status when the market debt was restructured in 2012. Provisions about the prohibition of monetary financing as per European treaties ruled out any central bank participation in a debt restructuring. However, based on current QE trends, it would be difficult for governments to generate meaningful debt relief through restructuring if such a significant portion of their debt were to be *de facto* ringfenced.

Beyond the unusual case of Lebanon, whose central bank is highly exposed to depreciated government securities, the recent remarkable government bond purchases by EM central banks in response to the COVID-19 crisis may turn into an acute source of vulnerability if perceived as a license to inflate the problem away.

⁶ The Eurosystem started its public sector bond purchase in 2015 and accelerated it in the context of COVID-19. As of December 2019, the ECB and the national central banks held EUR 2.2 trillion of sovereign debt (22% of total public debt). These holdings increased as of September 2020, reaching EUR 2.7 trillion. The Fed and the Bank of Japan held respectively 20% and 41% of their government debt at the end of March 2020. Overall, these three central banks hold now the equivalent of USD 12.3 trillion of public debt.

Overall, even though central banks can survive with negative equity for some time, to make a significant hole in the balance sheet of a central bank risks undermining confidence in the currency. At the end of the day, the "magic" of central banks is that people accept their liabilities as money — liabilities that they can create singlehandedly. Once that magic ends, the risk of de-monetisation lurks. Experience suggests that de-monetisation is even more costly than debt restructuring and can be devastating.

At a time when the average gross debt ratio for the G7 countries is about to reach 137% (IMF Fiscal monitor forecast for 2021) and when the balance sheets of those central banks issuing reserve currencies have expanded as never before, these new questions are coming to the fore.

What can be done?

Improvements in terms of debt crisis prevention and management are possible; but dramatic changes are unlikely. Debt restructuring will remain tailor-made and much more art than science.

Our experience in advising governments across the world brings some important lessons, as summarized below. We also explore some new ideas for debt restructuring negotiations.

Each situation is different and, except in rare circumstances, *countries should be wary of being put in any group or under any umbrella initiatives for debt forgiveness*. While generally well-intended, such initiatives that aim at across-the-board debt forgiveness carry a high risk of stigmatisation and a low probability that the solution will fit the needs of the country. To be sure, we do not mean to discourage accepting debt forgiveness when appropriate; we simply believe the answer to such offers is never simple and requires a nuanced analysis.

Improvements in terms of debt crisis prevention and management are possible; but dramatic changes are unlikely. Debt restructuring will remain tailor-made and much more art than science.

Only when debt is truly unaffordable, leading to socially unacceptable costs and ultimately destructive policy choices, should governments resort to a comprehensive debt restructuring right away. Otherwise, it is in the long-term interest of the country to make additional efforts to stabilize the debt trajectory and to realize liquidity relief that is as NPV neutral as possible.

Avoiding restructuring

Extendable debt instruments are useful innovations that could address liquidity problems in a simple way, though their value yet hinges on the universality of their application (i.e., to AEs, EMs, and DEs). The bonds would contain a clause according to which annual repayment (principal and interest) could be postponed by a year should, for instance, market interest rates exceed nominal growth by a given percentage — or any other relevant trigger, like the contingent convertible instruments banks are now required to issue. This could prevent the risk of immediate financial dislocation should interest rates shoot up — or simply normalize — in the future.

Managing liquidity problems

Notwithstanding that differentiating between liquidity and solvency can be fraught, it is critical to do so for countries that are only facing short-term funding difficulties, rather than long-term challenges. For such situations, the IMF is the natural port of call.

However, as said earlier, the IMF may be concerned that its own lending will fuel private capital outflows. For this reason, the IMF envisaged, after the Greek crisis, a staged approach to debt restructuring: it could impose, in a first phase, a mandatory rollover of the private sector's exposure to the sovereign for a given period until it can better ascertain debt sustainability.

In practice, it is extremely difficult to bring together a coalition of (private) fund managers that would be prepared to shoulder the IMF's effort through a voluntary and amicable standstill. Attempts to maintain banks' exposure to Greece during the first bail-out program in 2010 had very mixed results. Against this background, one could imagine assembling a coalition of sovereign wealth funds (SWFs) already invested in government-traded securities to abstain from selling or, better yet, to increase positions. This would be a way for SWFs to play a public policy role commensurate with their multi-trillion dollar weight. This would also avoid the risk that the IMF become the dominant (and privileged) creditor.

New ways to facilitate debt restructuring

- Marketable debt restructuring has benefited somewhat from recent legal innovations. The introduction of collective action clauses (CACs) in debt contracts and the single-limb versus dual-limb framework attempted to create a more favorable legal environment for orderly restructurings after the failed attempt to create a truly global legal mechanism for sovereign debt restructuring (SDRM). Still, *most CAC activation thresholds reflect a world where the sanctity of contracts matters more than the facility to manage occasional financial distress*. In the new context where public debt levels have reached exceptional levels, cases of debt restructuring will probably be more frequent, and it will be of greater import to be able to handle these cases diligently. To be sure, should CACs' activation thresholds be materially lowered — as part of a global initiative, bringing together AAA as well as sub-investment-grade issuers — the cost of capital may rise for the most financially fragile countries.

Most CAC activation thresholds reflect a world where the sanctity of contracts matters more than the facility to manage occasional financial distress.

- Useful instruments to reconcile the views of a debtor country and its creditors are value-recovery instruments (VRIs). They create a link between the future payments promised to bondholders in a restructuring and the actual payment capacity of the country (being related to GDP growth, trade or commodity prices, for instance). VRIs have proven useful — though often contentious — instruments in past restructurings (Argentina in 2005, Greece in 2012, and Ukraine in 2015). They can be particularly helpful in the last mile of a debt restructuring negotiation. Indeed, once all the negotiators have claimed having gone to the extreme limit of what they can concede in terms of *certain* value, such instruments with *contingent* value can help bridge the gap. However, such value is often discounted by creditors given their low marketability. Consequently, it appears that *some form of standardisation for the most conventional of these instruments (based on GDP, trade, or market access) could enhance their liquidity*, and hence increase their value at no additional cost for the issuer. Naturally, there is some trade-off between standardisation, so as to improve liquidity, and customisation.

Some form of standardisation for the most conventional of these instruments (based on GDP, trade, or market access) could enhance their liquidity.

- To facilitate orderly debt resolutions, it can also help to have an umpire. Such an umpire would opine on the debt capacity of the country and the degree of concessions that bondholders should make to put the debt back on a viable path. The IMF can and does usefully play such role. However, as it enjoys a preferred creditor status, its position may occasionally prove awkward when it is a large creditor itself: the higher the haircut inflicted on bondholders, the stronger its own position. This could recommend limiting the role of the IMF in such circumstances to evaluating the government's debt capacity, given the most likely growth and current account outlook: namely, weighing the maximum socially/economically tolerable primary balance against the maximum refinancing level above which there is a risk of locking in excessively high interest rates. Even with the economic parameters set out by an "independent" and respected institution, there is still substantial room to disagree among reasonable (and sometimes less reasonable) negotiators. Yet, while enough time must be allotted to thorough, good-faith deliberations, it is in everyone's interest not to prolong discussions beyond several months. The process is very intense and can distract both the government and the bondholders from other pressing issues. *Therefore, it could be envisaged, at the outset of any such negotiations, to select some impartial experts out of a panel constituted by the IMF, the WB and a representative group of world fund managers, for instance. Under some agreed conditions, should the negotiation get stuck in the sand, the protagonists would turn to these experts to arbitrate on what looks like a fair and reasonable deal.* They would commit to accept the judgment of the arbitrators.

Therefore, it could be envisaged, at the outset of any such negotiations, to select some impartial experts out of a panel constituted by the IMF, the WB and a representative group of world fund managers.

- History has also taught us that coordination among creditor groups and the adherence to a common set of rules is a public good that ultimately benefits all. Bilateral creditors' coordination in the context of an enlarged Paris Club would simply reflect the new reality of today's world. On the side of private creditors, stronger coordination among large fund managers and the inclusion of the new categories of commercial creditors (including

commodity traders) under the auspices of an *institution representative of the various classes of creditors* (e.g., the IIF) would, and hopefully will, create a more stable and efficient framework for discussion.

- Last, while sustainable investing has made significant strides recently, displacing hundreds of billions of invested money from conventional to "green" funds, it has played little role so far in debt restructurings. Yet, an increasing number of retail and institutional savers nursing portfolio losses as a result of a government restructuring could be assuaged by the comfort of conditioning such concessions on furthering tangible and observable green objectives. A framework already exists for green bonds, and the idea would be to use it to better align environmental and financial goals.

Taken together, several of these options aimed at enhancing the way governments and stakeholders handle sovereign debt restructurings are being discussed in different committees. The combination of increased instances of financial distress and heightened complexity calls for an intensification of such discussions, while bearing in mind that sovereign debt restructuring is always, and will always be, country specific.

Lazard's Sovereign Advisory Group is committed to serving its clients: governments looking for solutions to their complex financial problems. The sheer scope and importance of these matters also compels us to share our decades of experience for the broad public interest.

Contacts:

Pierre Cailleteau pierre.cailleteau@lazard.com – Thomas Lambert thomas.lambert@lazard.com

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