Barely a year ago, Argentina decided to announce a «selective default» of its debt after the ruling given by US judge, Thomas Griesa. Although this default is far from what is commonly perceived as standard default, it is paradigmatic of the difficulties involved in restructuring sovereign debt and serves as a warning of the need to implement and legislate for a general regime of prevention and resolution of crises in this area. Even more so given the growing trend of indebtedness in many countries.

Broadly speaking, we can assume that a country that has issued debt to finance its spending and investment has certain features in common with a company that has taken out debt to carry out its projects. If things go well, the debt is repaid with the returns from the investment and if things go wrong (either because of bad luck or irresponsibility), there is default. In spite of the similarities, the legislation
governing sovereign debt restructuring is not simple as it can easily come into conflict with one of the fundamental principles of international law, namely state immunity to the judicial decisions of other countries.\(^1\) It is not by chance that emerging countries regularly issue debt subject to laws other than their own: in general, US law in the case of debt issued in dollars, and English law if it is in euros.

As has already been mentioned, Argentina's case is paradigmatic of this conflict. When it went bankrupt in 2001, Argentina had debt in its own currency, in dollars and in euros totalling 100 billion dollars (this being the largest default in history until Greece took over in 2012). After restructuring its debt in 2005 and in 2010, it managed to convince 93% of its creditors to accept this but the remainder (mostly speculative funds) decided not to accept the deal and brought the case before the state of New York.\(^2\) In June 2012, Judge Griesa ruled in favour of the litigant funds and, two years later, based on the principle of pari passu (equal treatment for all creditors), it forced US financial institutions to cease all Argentina's payments to those creditors that had accepted the debt restructuring until those who had refused it had been paid, resulting in the country declaring a «selective default». This ruling upset the English courts which, in February this year, declared that Griesa's order to stop payments by the Argentine government affected investors who were covered by English law as they had acquired Argentine debt in euros and not in dollars.

This situation encouraged a large number of countries to propose, to the United Nations General Assembly, the need to draw up an international legal framework for sovereign debt restructuring in the case of default. Although this was not the first time this need had been debated, most advanced countries had not supported it in the past whereas, on this occasion, many decided to abstain instead of giving their usual «no» vote, opening the door to a possible entente. The argument that used to be put forward by a large number of developed economies is that collective action clauses (CAC), and the fact that debt was subject to either US or English law, provided a sufficient legal framework. Under CACs, if 75% of bondholders agree, the debt can be restructured for all its creditors.
The United Nations is not the only forum used to promote the development of a legal framework for this type of restructuring. One particularly important attempt has been made by the IMF in designing the Sovereign Debt Restructuring Mechanism (SDRM), which aims to make the restructuring of sovereign debt much easier by giving the majority of bondholders the right to agree on behalf of all the creditors (what is known as the power of the super-majority). The aim is to overcome one of the most common problems of CACs insofar as these require the majority to be negotiated individually for each debt issuance instead of as an aggregate.

However, the SDRM is not necessarily all good. Giving power to a super-majority could increase the risk of vote manipulation, weakening the rights of small investors. In fact, if the new framework allowed this super-majority to fall easily into the hands of interests in line with the country's government, there would be a higher risk of debt restructurings being misused, which could lead to a widespread rise in financing costs for emerging countries.

In short, we are still far from an agreed restructuring framework so it is vital to continue working to counteract the power enjoyed by a minority of creditors in the case of some sovereign defaults. Argentina's example has merely increased this need. Nonetheless, it is still not clear where to draw the line between the efficient, agile restructuring of debt and protecting investors' rights.


2. Most plaintiffs were opportunistic funds that had bought debt on the secondary market after the country had declared a default.

Tags
Government debt