

## **In the world of sovereign debt, bad ideas can never die on twitter**

**Jay Newman and Benjamin Heller JANUARY 27 2023**

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The world of distressed sovereign debt seems to attract bad ideas like no other, mostly generated by G-20 bureaucrats and the International Monetary Fund.

The most recent is the Common Framework for Debt Treatment, which is neither common nor a framework, but, rather, a recapitulation of the ad hoc nature of the process for resolving sovereign defaults. Twenty years ago it was the Sovereign Debt Restructuring Mechanism, a Trojan horse to establish a sovereign bankruptcy court presided over by the IMF, itself a creditor and expert witness. And let's not forget the Highly Indebted Poor Countries initiative, a program that relieves badly managed, corrupt countries of their obligations without generating growth, strong domestic institutions, or even enduringly clean balance sheets.

We also have the IMF and the G-7 to thank for the creeping loosening of collective action clauses, slyly converting them from a tool to facilitate orderly restructuring into a poison pill that renders sovereign debt functionally unenforceable.

But the granddaddy of bad ideas is the so-called Brady Plan, a gimmick that — had it not been designed and blessed by the US government — would have landed a lot of people in jail for accounting fraud.

Simply put, the Brady Plan packaged up defaulted and distressed junk sovereign debt with long-dated zero-coupon US Treasury bonds. The express purpose — the sole purpose — was to enable otherwise insolvent Western banks to avoid recognising huge losses on their portfolios of developing-country debt. Brady bonds never made any economic sense. But those were the days: when bank regulators did their patriotic duty, turned a blind eye to the deep holes in bank balance sheets and did . . . nothing.

Ironically, once the new bonds left bank balance sheets, bondholders and issuers spent much of the late 1990s and early 2000s unwinding collateralised Bradies — and sharing the not inconsiderable gains available from disassembling a structure that both sides found economically inefficient.

Now, two experts in complex financial and legal structures, Lee Buchheit and Adam Lerrick, are proposing to recycle the Brady Plan. The FT's Martin Wolf wrote in January about how the plan offers a potential escape route for “low and lower-middle income countries” that “have taken on too much of the wrong kind of debt.”

That's a fair point. But whether, as he concludes, that “reflects mainly on the lack of good alternatives” is open for debate.

There's plenty of room for scepticism about the mechanics of implementing the template, as FT Alphaville has already pointed out. Not least is that it proposes the creation of the kind of structural complexities that only a quantitatively-minded hedge fund trader could love.

To wit: “this proposal will convert the entire debt stock . . . into 25-40 year debt,” which “should reduce the net present value of the debt by more than 50 per cent and place the debt on a

sustainable path.” That reduction would be accomplished by offering bondholders a “cash downpayment” funded by new zero-coupon loans from the World Bank and the IMF.

Of course, the World Bank “can use derivatives to transform the . . . zero-coupon into a standard . . . floating-rate liability.” Then there’s a so-called Floor of Support Structure that will enable the debtor to magically discharge those new debts at maturity. Hmmm.

The template may be impenetrable but at least (like the Brady Plan) its heart is in the right place. Unfortunately, good intentions are not matched by clear purpose. As far as results, there will be a lot of new instruments for well-paid hedge funders and bankers to slice and dice and a lot of new money coursing through the system. How the plan will solve any real problems, though, is a mystery.

So many of these “big” ideas are generated by, or on the backs of, the international institutions. Inevitably, they are solutions in search of problems that would be better addressed directly. It’s a cunning bit of intellectual prestidigitation to conflate insolvency with “a debt problem” — as though the debt load landed on the country unbidden like an alien spacecraft.

Is the problem just the debt? Or is it the total failure to mobilise fiscal resources? Or poor management of those resources? Failure to create a fertile environment for growth? It is odd to think that — to take a random example of a country where talk is bubbling up about a possible debt restructuring — Nigeria needs a debt write-off, but nothing needs to be done about the fact that the country mobilises 6 per cent of GDP in tax revenue.

Another current event is the case of Sri Lanka: the IMF, as ever, is intent upon imposing its own opinion of debt sustainability. It’s past time for creditors to come up with their own benchmarks for sustainability, much in the way bank advisory committees did in the 1980s. Unlike the IMF, private creditors would propose actual standards for fiscal effort and reject sandbagged growth trajectories based on the soft bigotry of low expectations.

What never comes up in the myriad conferences on sovereign debt, or in the research and discussions led by the official sector, are the root causes of sovereign debt defaults: corruption, weak governance and domestic institutions, refusal to forego borrowings in foreign currencies, and the failure to prevent defalcation, much less to recover ill-gotten gains.

At some level, Buchheit and Lerrick understand that serial defaulters have problems that go beyond the mere existence of debt. The one sensible piece of their proposal calls for structural restraints on borrowers’ ability to re-lever themselves with new borrowing after going through their neo-Brady Rube Goldberg machine. They know better than to put a non-recovering alcoholic next to an unlocked liquor cabinet.

Yet, for the official sector, feckless fiscal performance, political mismanagement, and the concomitant sovereign debt problems are more an opportunity than a problem. Problems, after all, are their *raison d’être*.

**Countries are most often poor because they are badly governed by a political class intent on collecting rents, not providing honest services. Fancy templates, frameworks, initiatives, and plans ignore root causes of the human misery that results from this misbehaviour. They are misdirection, solve nothing, obscure the underlying problems, and absorb attention that might otherwise be productively directed at solving them.**