

# 14 Comments on “Sovereign bond restructuring: collective action clauses and official crisis intervention”

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Chapter 13, by Kletzer, is excellent. It brings rigorous economic theory to bear on an important practical policy issue and reaches conclusions that make sense. But I will concentrate my remarks on the issues where Kletzer and I appear to be in less than complete agreement.

The formal model has a number of familiar features as well as a few non-standard ones. A single, infinite-lived, risk-averse borrower with time-additive preferences and a random, perishable endowment faces a large number (probably a continuum) of infinite-lived risk-neutral lenders. The borrower’s objective is to maximise expected utility of lifetime consumption. There is no third-party enforcement of contracts (contingent or simple). There is uncertainty, but no asymmetric information. The fallback position of the borrower and the lenders is financial autarky. It is not clear to me whether it might ever be individually rational for the borrower to become a lender. Is it ever rational for him or her to build up a stock of financial assets which can then be run up or down to buffer endowment shocks?

The strict concavity of his or her period utility function implies that the borrower is interested in two kinds of consumption smoothing: (1) consumption smoothing over time (intertemporal consumption smoothing); and (2) consumption smoothing across states of nature (diversifying consumption risk). And the borrower fails to achieve the command optimum because he or she labours under two handicaps: (1) an inability to commit his or her future actions; and (2) he or she is restricted to simple (non-contingent) debt contracts.

Third-party enforcement or some other ad hoc commitment mechanism is required to solve the commitment problem. Simple, multi-period debt contracts with third-party enforcement permit full consumption smoothing over time, but not across states of nature. Renegotiation can be used to mitigate the restriction on risk sharing caused by the assumption that only simple debt contracts can be used, but without third-party enforcement it will not resolve inefficiencies due to lack of commitment.

My main disagreement with Chapter 13 (or rather the main reason why the conclusions of the chapter cannot be applied directly to real-world renegotiation of sovereign debt contracts) is that the set-up of the model, and therefore its conclusions, are too “Coasian”.

Kletzer takes as his welfare benchmark the efficient, perfect (roughly time-consistent) equilibria of the (implied) infinitely repeated game in which any agent (borrower or lender) can make a non-negative transfer of resources less than or equal to the amount of his or her current endowment.<sup>2</sup> He shows that the efficient self-enforcing equilibrium can be implemented using one-period state-contingent contracts, with free entry and exit by lenders. He then restricts his welfare comparisons to the class of self-enforcing contingent contracts. That is, in his benchmark world, there is still no third-party enforcement, but contracts can be made contingent on realisations of mutually observable random variables. Note that this welfare benchmark is a restricted, second-best welfare benchmark, as only the efficient equilibria among the class of perfect equilibria are considered. It is easily established that restricting contracts to be non-contingent does not in general permit (constrained) efficient perfect equilibria to be supported. For simple (non-contingent) debt contracts to support any equilibrium, we must structure the support of the endowment distribution and the permissible contracts to rule out “bankruptcy” or “default” (when the amount due on the debt exceeds the full realisation of the borrower’s random endowment).

This restriction eliminates the scope for welfare improvements through third-party enforcement. Third-party enforcement is key to the viability of welfare enhancing contracts when the continuation value of the contract becomes negative for at least one of the parties. Third-party enforcement is welfare enhancing primarily because it resolves intertemporal commitment problems, not because it is essential for dealing with risk and uncertainty.

Kletzer then considers a different kind of repeated game using the same basic building blocks. Instead of single-period state-contingent contracts he considers simple (non-contingent) one-period debt contracts plus the possibility each period, after the uncertain random endowment of that period has been revealed to all parties, of renegotiation. Since the possibility of renegotiation effectively introduces state contingency into the contract, it is not too surprising that the combination of one-period non-contingent debt contracts plus unrestricted and costless renegotiation each period supports the same (constrained) efficient perfect equilibrium as the single-period contingent contracts.

Kletzer then looks at how different kinds of restrictions on the ability to renegotiate incomplete contracts affects welfare. These restrictions can be interpreted as stylised versions of the bond covenants that bind creditors together and that are enforced by creditor country governments. They are (a) enforcement of seniority rights among creditors and (b) collective action clauses.

The first proposition established is that renegotiation with seniority rights of simple loan contracts supports a (constrained) efficient perfect equilibrium. It is not necessarily true that any (constrained) efficient perfect equilibrium can be attainable through renegotiation of simple loan

contracts when seniority rights are enforced. This makes sense, since seniority rights are a restriction on the capacity to renegotiate. If I understand it correctly, this means that seniority rights do not necessarily hurt, but they do not help either. Like the earlier result that renegotiation of simple contracts supports constrained efficient equilibria, this proposition requires some strong “Coasian” assumptions, in particular common knowledge in the repeated game. Every lender observes the obligations of the borrower to every other lender and the actions of each lender, and also knows the preferences and endowments of all participants. Negotiation does not require time or other scarce resources.

The second proposition established in Chapter 13 is that renegotiation under unanimous consent can be costly: holdouts or vulture funds (such as Elliott associates) can cause inefficient perfect equilibria to be supported.

The third result concerns the efficiency of renegotiation with collective action clauses (CACs); that is, renegotiation under qualified majority or supermajority consent. It is shown that CACs can eliminate the costly wars of attrition in restructuring that can occur under unanimous consent. The intuition offered for this result is that competition between creditors (bondholders) to be the pivotal voter can be used to eliminate the rent to holdouts. I do not understand this. What determines the size of the smallest qualified majority to support an efficient perfect equilibrium? Does any qualified majority rule always support an efficient perfect equilibrium? Does any qualified majority rule support *only* efficient perfect equilibria? Are all efficient perfect equilibria always supported by any qualified majority rule? It would be helpful to be given insight into these questions.

The final proposition is that aggregation (the requirement that all bond claims be renegotiated together, and presumably on the same terms) may (or will) not increase efficiency over and beyond what can be achieved with just collective action clauses. Again, the assumption of common knowledge is central to this result. This proposition is intriguing, because it suggests that the key reform of the international financial architecture that should be pursued is CACs rather than the setting up of a sovereign debt workout tribunal such as the Sovereign Debt Restructuring Mechanism recently proposed by Anne Krueger.<sup>3</sup>

There is, however, some distance between the model and a reasonable simulacrum of contemporary interactions between sovereign borrowers and private creditors. The Coasian core of the model is recognised very clearly by Kletzer:

In the bare-bones institutional structure of the consumption smoothing model of sovereign debt, any mutual beneficial renegotiation is possible after any history of the relationship between the borrower and lenders. Nothing impedes a mutually beneficial renegotiation.

(Chapter 13, p. 240)

The model explicitly ignores all constraints on negotiation, let alone on period-by-period renegotiation. Forcing all reluctant creditors into a single corral with the debtor may be easier than having a large number of simultaneous negotiations going on all of the time. Thus the model overstates what renegotiation is likely to be able to achieve in the real world. Third-party enforcement probably has more going for it than the model can handle.

The model also ignores the gains from third-party enforcement to the extent that third-party enforcement resolves or mitigates the commitment problem. The efficient perfect equilibria are only constrained efficient, that is, they are inefficient relative to a model of contingent contracts (or renegotiation) with commitment. The command-optimum can only be supported by a credible commitment to contingent response rules, rather like the optimal “innovation contingent” but not time-consistent decision rules I analysed in a totally different context a long time ago (Buiter 1981). Third-party enforcement (or the incurable honesty of all players) is necessary to support fully efficient equilibria.

Chapter 13 represents a useful and interesting benchmark. Absorbing its message was for me rather like studying the First and Second Welfare Theorems: the real understanding I gained came from pondering what had been left out of the model, and what difference these simplifying features were likely to make.

I am not yet willing to give up on the importance of third-party (exogenous) enforcement of contracts as a precondition for efficient economic arrangements. The state or its supranational counterpart has no effective substitutes, be it the invisible hand or the inaudible negotiator.

## Notes

- 1 The views and opinions expressed are those of the author. They do not necessarily reflect the views and opinions of the European Bank for Reconstruction and Development.
- 2 This will not in general be a command optimum, because a command optimum allocation will in general require commitment, that is, it will not be time-consistent or perfect.
- 3 The SDRM would be an IMF-on-steroids that can order debt service standstills, adjudicate disputes between a sovereign borrower and all its lenders and impose far-reaching conditionality on the borrower.

## Reference

- Buiter, Willem H. (1981) “The Superiority of Contingent Rules Over Fixed Rules in Models with Rational Expectations”, *Economic Journal*, September, 91, 647–670.

