SUPPORT MEMORANDUM

Ref: S.4747 Hoylman-Sigal / A.2970 Fahy

In 2019, debt for developing countries stood at a 50-year high. Since then the Covid-19 pandemic, the Ukraine war and rising interest rates in major economies' central banks exacerbated debt vulnerabilities.

An important development in the decade preceding the pandemic was the growing role of private creditors. In 2010, the share of developing country debt held by private creditors was 46 percent, according to the World Bank. By the end of 2021 it had shot up to 61 percent. The trend holds even in the poorest countries, where the share of private creditor debt went from 5 percent to 21 percent in the same period. Within the universe of private creditor debt, the largest increase in the last 15 years occurred primarily in the form of bonds, not bank loans.

In this context, establishing an orderly way to restructure sovereign debt is of paramount importance. The need for a fresh start is both a matter of efficiency and equity.

Within virtually all countries, mechanisms to restructure debts exist in the form of bankruptcy laws, which are now seen as a vital part of market economies, yet there is no comparable mechanism for the debts of sovereigns.

In the wake of the pandemic, when the G20 agreed on a temporary Debt Service Suspension Initiative (DSSI), private creditor participation was voluntary. No debtor dared to stop paying their private creditors, for fear of lawsuits and credit downgrades, and no private creditor stopped collecting. Conversely, the G20 Common Framework for Debt Treatments beyond the DSSI, agreed on in November 2020, entails a clause—the Comparability of Treatment (CoT) Clause—that specifies that private creditors must contribute on comparable terms to the debt relief countries receive from bilateral official creditors. But there is no way to enforce the clause. So debtors are left to their own devices and have to negotiate with their creditors to accept this provision. Some countries with large economies may come to the negotiating table on comparable terms with their creditors. The poorer the country, and the smaller its bargaining power, the less likely this is to be true. Poor countries are typically at a huge disadvantage in bargaining with their creditors. Often, debtor countries are squeezed so hard for payment that they do not restore debt sustainability, see no economic recovery, and default again after a few years.

Even when countries would benefit from a debt restructuring they continue to service their debts. When faced with the choice of renegotiating their debt contracts with their private creditors or the commitments with their people to provide essential services and critical investments for growth and resilience, they choose to avoid the risk of the mayhem of facing lawsuits by private creditors in foreign courts. This is a story we have seen many times before: Eventually a default on their debts becomes unavoidable. But it comes at an unnecessarily high cost, both for the debtor and the collective of creditors. The incentives for debtors and creditors need to be changed urgently to support restructurings when they become necessary.

We have long advocated the need for improvements in the frameworks for resolving unsustainable sovereign debt burdens. This is why we strongly support the Hoylman-Sigal/Fahy New York Taxpayer and International Debt Crises Protection Act (S.4747 and A.2970), currently pending in the New York State Senate and Assembly.

The bill will play a powerful role in changing the incentives of private creditors to hold out, and thus also of sovereign debtors to postpone necessary restructurings. As more than half of private creditor contracts are governed by New York State law, the legislation does something very simple. If a borrower applied for an international debt relief initiative, any private creditor attempting to sue in a New York court would see its claim against such a borrower reduced to the proportion collected by public and other creditors participating in the initiative. This would apply to any initiative under the scope of the bill – whether the G20 Common Framework, an international ad hoc effort like the one currently going on in Sri Lanka, or a Paris Club agreement.

The legislation would instantly provide the protection for **borrowers** that need a debt renegotiation. Instead of fostering a new and potentially lengthy judicial process in New York courts, where a poor country can hardly afford it, it encourages the creditor to avoid litigation altogether and join a collective solution. Put simply, the legislation changes private creditors' and debtors' incentives, making litigation less attractive and cooperation more attractive. Because of this immediate protection, borrowers will be able to reduce the length of debt crises and the costs in budget cuts that affect the most vulnerable within them.

The bill will protect **investors** in two important ways. First, all would benefit from a more timely and orderly path for troubled countries to regain growth and repayment capacity. It will also secure intercreditor equity and protect against potential free-riding by other creditors. Indeed, every creditor will be reassured and proceed under the newly acquired certainty of a standard of protection.

The law will also protect in two ways the **taxpayers** who fund the bilateral official creditors in international debt relief initiatives from bailing out private creditors. First, it directly ensures that private creditors contribute their fair share of debt relief by placing them on parity with bilateral official creditors. This will represent a refreshing change to the current framework in which historically private creditors extract, on average, 20 percent better terms than bilateral official creditors. Importantly, this public sector comparability is a standard that contract-based solutions that rely on a supermajority of creditors agreements cannot guarantee. Second, it will encourage earlier debt restructurings, and so reduce the time private creditors have in prolonged debt crises to head for the exit and shift the burden of their over-lending to public creditors that customarily act as crisis lenders—prominently the International Monetary Fund.

This element of taxpayer protection provides safeguards to **financial stability** in the current fragile sovereign debt restructuring system. In the absence of a sovereign bankruptcy mechanism, official bilateral creditors have taken the lead historically in finding agreement in sovereign debt restructurings. So far this has been possible with the support of their taxpayers. What would happen, though, if taxpayers, seeing that their money consistently goes to bail out private creditors and boost corporate profits, began to revolt and oppose the use of their money for such purposes? The sovereign debt restructuring machinery could come to a standstill, with unpredictable consequences for global stability.

While the Hoylman-Sigal/Fahy legislation does not create a sovereign debt bankruptcy framework, it does not interfere with the creation of one. Indeed, should the conditions emerge for a rules-based sovereign debt restructuring framework, the bill is crafted in such a way that it will complement it. Any sovereign debt bankruptcy system will likely need to be written into the legal framework of multiple jurisdictions. With the large share of contracts under New York State law, doing so in New York will be essential. The Hoylman-Sigal/Fahy bill will have effectively already done that, bringing us one step closer to the creation of an effective sovereign debt restructuring framework.

In short, the Hoylman-Sigal/Fahy bill would protect debtors, creditors, taxpayers and financial stability. This is why we strongly urge the passage and enactment into law of the New York Taxpayer and International Crises Protection Act.

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Joseph E. Stiglitz, Nobel Laureate, economics professor at Columbia University and co-President of the Initiative for Policy Dialogue.