ISE Institute for State Effectiveness

DEVELOPMENT PRACTICE NOTE
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Revocable Debt Relief: **Transforming a Liability into a Contingent Liability**

As of 2016, Europe's prospects for inclusive and sustainable growth remain low. The regional and global debt crisis continues to constrain lending, investment, consumption, and saving in the EU and core markets. Brexit is threatening a disunited Europe. A focus on austerity, rather than public sector efficiency, endures. Monetary policy powers are weakening; the use of seignorage powers have been used widely over a long period; official interest rates remain at or close to zero around in most of the world's central banks; and the effects of competitive devaluations are observable.

While going for inclusive growth must be the first tier mantra, sovereign and private debt relief must also be a core part of a durable solution. What actually constitutes a high debt is an important issue to discuss, but given the general acceptance that debt levels are too high, it is sufficient to bypass this topic for now. As soon as it is believed that debt is too high, trust and therefore credit worthiness plummets and in the case of countries, sovereign risk premiums soar in the absence of monetary interventions. So getting the debt down is still key.

But how does one reduce debt in the absence of growth and effective fiscal and monetary policies? Sovereign debt relief could restore confidence and would provide a solid foundation for rebound growth. *The problem is securing necessary levels of debt relief quick enough and in a way that is politically feasible.*

Debt relief is the partial or total forgiveness of debt – or the slowing or stopping of debt growth – owed by individuals, corporations, or nations. It can be achieved through many different ways through direct mechanisms by the original creditor, or through indirect means through forms of debt restructuring like debt consolidation (taking a lot of small high cost loans and bundling them up into a large concessional loan).

Arguments against debt relief include worries that it can create a moral hazard, where debt relief can lead to unchanged or deterioration in risk-taking behaviour since the costs of risk-taking is not borne by the entity taking the risk, and concerns that funds do not get used efficiently or as intended. Solutions to these valid criticisms involve the use of sanctions, conditionalities (including around transparency, accountability and system strengthening) and heightened surveillance. Experience has shown, however, that there are badly-designed conditions and well-designed conditions.

Much experience with systems to forgive debt of developing countries was gained during the noughties through multilateral efforts by the IMF, World Bank and the Paris Club. Much was learned in this period, particularly through the Heavily Indebted Poor Countries (HIPC) debt forgiveness initiative and its extension, the Multilateral Debt Relief Initiative (MDRI). Taking on much bigger debt problems of high-income countries

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is much more difficult, primarily due to the size of amounts involved and players involved.

To date, the banks have been the primary beneficiaries of debt relief. Banks have already received significant amounts of effective debt relief through: i) transfer of toxic debt to sovereign governments; ii) deposit guarantee contracts with sovereigns, that in their absence would have resulted in prohibitively costly additional debt or bankruptcy; and iii) strengthening of bank balance sheets through quantitative easing and recapitalization mechanisms.

Some limited forms of debt forgiveness and assistance have been given to families, including through moratoriums on interest payments and arrangements for no or low-consequence on default. It has also been argued that government can influence banks directly to keep lending rates low in order to avoid increased levels of bad debts and increased social harm, which can occur when the bank is government controlled or heavily bailed out. The consequence may be that the market for new loans fails to work – i.e. there is significant demand for borrowing if capital were available even at a higher interest rate, but the market is prevented to work by low interest lending requirements.

The form of sovereign debt relief that high-income sovereigns (such as Greece) receive are primarily concessional lending – where governments are provided with a loan at more favourable terms than they would have otherwise been restricted to in private money markets. Examples include lower interest rates, grace periods for repayment and longer repayment periods. Another example is a sovereign debt exchange with the private sector (Greece).

Are there any other debt relief mechanisms that are politically viable?

A politically-viable debt relief mechanism is one that attaches debt relief as a long-term condition that also forms the basis of a sanction. The system is more likely to be an effective deterrent against poor economic governance in the future and provides positive incentives for even better governance in the future. It would work this way:

- **Common and context specific medium-to-long term macro-fiscal, economic and social governance goals,** adjustment paths and performance targets are set up and by supported action plans and performance indicators;
- **Debt relief sufficient to bring debt to appropriate levels is programmed to be achieved over time,** is conditional but, in a way, can be immediate:
    1. **The amount of debt relief is tranched over the medium term,** subject to the amount of debt relief required to achieve sustainable or appropriate levels;
    2. **Each debt relief tranche is made conditional** on sufficiently meeting performance targets;
    3. **Debt relief tranches to be determined as irrevocable or revocable debt relief.** The revocable debt component would then be subject to another set of ongoing set of increasingly conditions linked to performance.

Revocable debt relief tranching is the most critical step for political feasibility in combination with the medium-to-long term nature of the program. Politically, it is much easier to sell a debt forgiveness program that is seen to be tough and doesn't involve transfer of revenues or cash reserves (though it is essentially a transfer of non-current financial assets). The major loss over the medium term to the debt forgiver is the forgone interest payments. All other steps are fairly standard approaches to designing debt-restricting programs.

The accounting for "revocable" debt relief is innovative as it is straightforward: i) ***debt is removed over time off the recipient government's balance sheet and into the notes as a contingent liability*** – contingent on the recipient government failing to deliver reform, the debt can come back in part or whole over time; ii) sovereign debt holders move their dodgy sovereign asset out of their balance sheet and in to their notes as a contingent asset – contingent on the recipient government failing to deliver growth and reform, the asset can return to their balance sheet. Terms for revocability could last up to 25 years and could allow growth in the off-balance sheet principal. Operating statement effects could be handled below the line or as equity adjustments.