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GDP-linked Bonds:[1] A Case for Broader Market Acceptance?

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The Greek sovereign debt crisis has brought into focus the current system of sovereign debt financing, and provided an opportunity to reflect on how that system serves sovereign borrowers and participants in the international credit markets that fund them. While most recent precedent for the pattern of over-borrowing/lending followed by (potential) default and/or restructuring currently being played out in Greece comes from the Emerging Markets (EM), the Eurozone crisis shows that even developed economies can be vulnerable to market forces, and even developed country debt can be a risky investment. The Eurozone crisis is already showing signs of changing the current system in some subtle and not so subtle ways that do little to enhance the predictability and certainty of contract on which the markets rely. Therefore, the time may be ripe to consider new instruments that can help break the current pattern of over-extension and restructuring by realigning the interests of sovereign borrowers and lenders to their mutual benefit. GDP-linked bonds may fit that bill.

Up to now the international sovereign bond markets have provided governments across the credit spectrum with (relatively) low cost, long-term financing and in return provided traders and investors with a liquid and profitable trading market. While there have been defaults and/or restructurings in various EMs over the years, these have been resolved more or less successfully, albeit in a messy *ad hoc* sort of way. (In brief, when a country is unable to service its debts the IMF steps in with a reform programme and short-term liquidity; private creditors take losses on their current investment, but receive new, liquid instruments in return; and the country preserves its market access for its longer term financing needs.) So long as sovereign debtors have shown a willingness to constructively engage with the IMF and their creditors, the system has more or less worked, so that both sovereigns and their creditors have understood where they stand. Restructurings are time consuming and expensive for all parties, but perhaps in light of the proliferation of sovereign credit default swaps (CDS), which insure against potential default (and have developed into a tradable asset in their own right), there has been little incentive either for private creditors or the debtors to change the system.

However, many aspects of this *ad hoc* system have troubled politicians, policy makers and so-called civil society for many years. In particular, politicians have been troubled by the actions of so-called "rogue" creditors who have resisted taking losses on their investments while tax-payers have funded bail-outs or "forgiven" debt outright; and policy makers and civil society have been concerned about the toll that sovereign debt crises take on the affected population, particularly in more vulnerable economies. This latter concern was exacerbated by the fall-out from the 2001 default in Argentina and the attendant social unrest. Putting aside the fact that many would argue that Argentina was the author of its own fate by not allowing the *ad hoc* system to work (it refused to sign up to an IMF programme, did not constructively engage with its private creditors, and it has still not regained market access), the implications so far of the Greek crisis, regardless of what the Private Sector

[1] *See generally*, "GDP Bonds – Making it Happen," Stephany Griffith-Jones and Krishnan Sharma, DESA Working Paper 21, April 2006 (and References cited therein, "GDP-linked Bond Literature") (http://ideas.repec.org/p/une/wpaper/21.html).

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Involvement (PSI) ultimately looks like, is that creditors no longer know where they stand. (And this does not take into account the shifting sands of financial market regulation more generally.)

Set in a broader context, the policy responses to a number of EM sovereign debt crises over the past decades leading up to the current Eurozone debt crisis have resulted in private creditors – particularly bond holders – having fewer protections and fewer options. These policy responses have included such diverse official sector actions as (a) the Paris Club's extension of the convention of comparability of treatment to specifically include bondholders (1999); (b) the IMF's failed SDRM proposal that nevertheless ushered in the broad-based inclusion of Collective Action Clauses (CACs) in NY-law governed EM sovereign bonds (2002); (c) the UK's adoption of legislation limiting enforcement in UK courts of certain HIPC debts of commercial creditors (2010); (d) the EU's embedding PSI in its official stance for resolution of the Greek crisis back in October 2010 (raising suspicions that PSI will be required for other Eurozone countries, although this has been denied); and, if the rumours are true, (e) the apparent decision of Eurozone governments – to be applied retroactively and unilaterally – to include CACs in their existing (and future) bonds.[2] If Greece can pull off a "voluntary" restructuring and avoid triggering any "credit event" in any existing CDS, market participants will have to review their options for extending credit and hedging risk going forward.

The Case for GDP-linked Bonds

As pointed out in the GDP-linked Bond Literature,[3] GDP-linked bonds issued as (a large enough) part of a broader sovereign financing portfolio could break the cycle of unsustainable debt build-up and (potential) default by realigning the interests of sovereigns with their creditors such that payment streams increase based upon pre-defined measures of economic growth, and decline in times of stress. They thereby reduce the chance of default. They could also limit the need for sovereign debtors to refinance or borrow more in difficult economic times (and at higher rates) potentially precipitating a crisis. In other words, GDP-linked bonds, if properly designed, could provide both sovereigns and their private creditors with a greater degree of certainty and predictability than the current boom/bust system, and significantly reduce losses.

A potential additional benefit of broader acceptance of GDP-linked instruments would be the greater scrutiny of, and inevitable improvements to, GDP reporting. More reliable (and faster) GDP reporting would not only benefit a wider universe of investors,[4] but would improve rating agencies scoring of sovereign performance. Moreover, GDP-linked bonds, which provide investors with "equity"-type exposure to the broader economy,[5] could provide interesting diversification opportunities between uncorrelated economies, if these instruments were issued by a combination of EMs and more developed countries.

While the intellectual case for them is quite strong, they have yet to gain currency in the broader market and amongst issuers. Some would argue that the fact that these bonds have not already become a feature of the international financing architecture implies that they are not viable. There are, in fact, a variety of reasons why GDP-linked bonds have not caught on in their own right. One issue is the association of performance-linked debt with distressed sovereigns. In fact, performance-linked instruments such as oil warrants or "value recovery rights" that pay a dividend

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[2] This list does not include the impact of current sovereign immunity law (as applied by the courts), which has tended to further insulate sovereign debtors from creditor action.

[3] *See,* footnote 1, above.

[4] *See,* Griffith-Jones, above.

[5] *See*, "The Case for Trills: Giving the People and their Pension Funds a Stake in the Wealth of the Nation", Mark Kamstra and Robert Shiller, August 2009. (http://cowles.econ.yale.edu/P/cd/d17a/d1717.pdf).

upon reaching certain oil price targets were issued in the Brady restructurings of Mexico, Venezuela, Uruguay and Nigeria. GDP-linked warrants that pay a dividend based upon specific growth formulae were issued in the Brady restructurings of Costa Rica, Croatia and Bulgaria, and most recently in Argentina's 2005 restructuring. In other words, these types of instruments have been included as "sweeteners" in restructuring packages over the past several years (and may yet play a part in the Greek restructuring). However, this "reputational" problem may translate into higher premiums for potential issuers. There are also higher costs associated with issuing something other than a plain-vanilla bond, particularly an instrument that the secondary market may not price and trade efficiently, at least at first.

Through these EM precedents, market participants are gaining valuable lessons about how to structure and value these instruments. Discussions continue, meanwhile, about the utility of GDP-linked bonds as stand-alone instruments in their own right for more vulnerable economies. Interestingly, in recent years there have also been suggestions that even developed economies could benefit from issuing GDP-linked instruments.[6] And a debt swap of conventional bonds for "growth bonds" was recently proffered as a potential solution for the troubled Eurozone.[7]

In response, a number of market participants have recently indicated that there is interest in further analysis of GDP-linked instruments, and have begun to break down the legal, practical and technical issues that would need to be addressed if these instruments were to be accepted by the broader market.[8] These issues are not insignificant, but if market participants (and potential issuers) can agree on the benefits of developing a GDP-linked bond market, even the most daunting challenges can certainly be addressed. Perhaps now is a good time for policy makers, potential issuers and market participants to consider the advantages of counter-cyclical instruments like GDP-linked bonds and work together to address and resolve the constraints to their acceptance in the broader market.

We are currently discussing how to advance this topic with market participants and leading trade associations, and participating in discussions with experts on these instruments. For more information, comments or questions, please contact Starla Griffin at starla.griffin@slaneyadvisors.com.

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[6] *See*, Shiller and Griffith-Jones, above.

[7] See, "Growth bonds a win-win for troubled Eurozone", Stephany Griffith-Jones, Robert Akerlof, Marcus Miller, 9 December 2011.

[8] *See* EMTA Memoranda: "GDP-Linked Securities – Continuing the Dialogue with the Market", 3 August 2010 and "GDP-linked Bonds (Performance Bonds): Initial Market Participant Feedback", 14 October 2010 (copies available on request).