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Author: Yasin K*ü*rşat Önder

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Asset Backed Contracts and Sovereign Risk

Yasin Kürşat Önder

Central Bank of Turkey, Idare Merkezi. Istiklal Cad. 10 Ulus, 06100 Ankara, Turkey

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Abstract

A fundamental problem with sovereign default is the lack of a legal enforcement mechanism. Since the 1920s, there have been an ongoing set of initiatives undertaken by the League of Nations and the UNCTAD to set international laws on borrowing and lending standards, all of which have failed. To address the unenforceability problem, this paper proposes to use asset backed contracts where the usufruct of the asset transfers to the asset holder. Unlike conventional sovereign borrowing, there are international laws governing asset backed contracts which allow the international assets of a country to be seized. This paper exemplifies on the idea that asset backed contracts, which are also widely practiced in Islamic finance, can provide a solution to unenforceable sovereign debt contracts. The paper focuses specifically on Argentina which has defaulted twice in 13 years. If Argentina had utilized asset backed contracts prior to its 2001 debt default, it would have gained from the following advantages: higher debt-to-GDP ratios, larger welfare gains, lower probability of default and thus lower borrowing costs.

Keywords: sovereign default, sovereign debt, equity based contracts, asset backed contracts, Islamic finance, GDP-linked bonds
JEL: F30, F34, K33

1. Introduction

The President of Argentina has announced in June 2014 that Argentina will not abide by the U.S. Supreme court decision ordering payment for their default in 2001. The court ordered that until Argentina settles its outstanding debt owing from the 2001 default, it is barred from making any payment to lenders who own restructured bonds. In the absence of international standards on enforceability, these matters pose a dichotomy of support and opposing

Email address: `kursatonder@gmail.com, Phone: +90 (312) 507-5671` (Yasin Kürşat Önder)

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