

**Initiative for Policy Dialogue and
United Nations Department of Economic and Social Affairs**

SOVEREIGN DEBT TASK FORCE

**REPORT OF THE MEETING OF AUTHORS
Columbia University, October 15-16, 2004**

[Barry Herman]

Authors invited to prepare papers for a volume on policy issues regarding sovereign debt of developing and transition economies met at Columbia University on October 15 and 16 under the leadership of Joseph Stiglitz, President of the Initiative for Policy Dialogue (IPD), and José Antonio Ocampo, Under-Secretary-General for Economic and Social Affairs at the United Nations. The meeting was part of a project to develop a book for the international policy community and, in particular, was conceived as a resource for the set of multi-stakeholder dialogues called “Sovereign Debt for Sustained Development,” which are being organized in 2005 by the United Nations Department of Economic and Social Affairs (DESA), in cooperation with the International Monetary Fund (IMF), the World Bank and the United Nations Conference on Trade and Development (UNCTAD).¹

Shari Spiegel, Managing Director of IPD, and Barry Herman, Senior Advisor in the Financing for Development Office of DESA, moderated the discussions at the authors’ meeting. All but three of the authors were able to attend.² In addition four guests joined the discussion: Nouriel Roubini (NYU), Brad Setser (Oxford),³ Emily Altman (Morgan Stanley), and Lee Buchheit (Cleary, Gottlieb, Steen and Hamilton), plus Akbar Noman of IPD. A team from DESA and Columbia took notes during the meeting, from which this report has been prepared.⁴

Following is a review of the meeting, which attempts to place the papers and discussions into a structure that the book might take. The agenda of the meeting, short biographies of the participants, outlines of the papers, and drafts that were in hand at the meeting are available separately from Shana Hofstetter at IPD (sh2162@columbia.edu).

¹ DESA circulated an “Issues Paper” to the Meeting of Authors that had been prepared in collaboration with its partner international organizations to help shape the discussions, which are planned for March 7-8 at the United Nations in New York (middle-income country issues), March 16-17 in Maputo, Mozambique (low-income country concerns), and June 6-7 in Geneva (as part of UNCTAD’s Inter-Regional Debt Management Conference).

² Daniel Cohen, Richard Portes and Henry Northover were unable to attend but are committed to providing papers for the book.

³ After the meeting, Brad Setser agreed to prepare an additional paper for the book to highlight political features in the development of the proposal to create the Sovereign Debt Restructuring Mechanism.

⁴ The team comprised Ana Cortez, Sergei Gorbunov (also an author), Eva Hanfstaengl and Krishnan Sharma brought by DESA, and Jean Chen and Jennifer Samuel from Columbia. Their assistance is greatly appreciated.

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Historical and theoretical framework

José Antonio Ocampo and Joseph Stiglitz led off the discussion with presentations that provide an overall framework for the discussion of policy questions on sovereign debt. Ocampo observed that sovereign external debt difficulties have been treated differently in different historical periods and with different economic consequences in the indebted countries. Little in the international treatment of sovereign debt crises should be assumed immutable. Stiglitz looked analytically at sovereign bankruptcy as a concept and its implications for better and worse international workout mechanisms.

In further setting out the context, Shari Spiegel pointed out that the objectives of a sovereign bankruptcy regime should include both ex-post and ex-ante efficiency. Ex-post efficiency entails giving countries a ‘clean slate’, so that they can re-start growth and not get caught in a cycle of needing to restructure their debt repeatedly. However, most of the countries that have restructured their debt over the past decade did not reduce their debt burdens enough to sufficiently re-charge growth. Ex-ante efficiency embodies incentives for appropriate behavior of creditors and debtors prior to bankruptcy (for example, discouraging moral hazard and weak credit screening). In her view, the debate on debt restructuring mechanisms had not paid enough attention to these two points.

Lessons of history

Ocampo's presentation centered on whether the sovereign debt defaults and restructurings in the 1930s when compared to the experience in the 1980s held lessons for today. In the particular case of Latin America, despite a more adverse trade environment and widespread sovereign default, regional growth of gross domestic product (GDP) in the 1930s was higher than in the 1980s. In the global and regional context of the time, the Roosevelt Administration took a favorable attitude to sovereign debtors, and private creditors did not try to squeeze countries. Creditors thus often rescheduled on relatively favorable terms and additional finance was made available, as through the US Export-Import Bank (founded 1934). In contrast, non-defaulting Argentina faced higher costs through continued debt servicing (owing to its attempt to preserve access to the UK meat market) than had it defaulted. Creditors' and debtors' attitudes changed in the 1980s.

Ocampo put forward a few comments in this regard:

1. Moral hazard and international financing: Lenders did not want to generate incentives to default and debtors went to extremes to avoid default in the 1980s and the 1990s, as costs of default were perceived to be high. However, for those countries that defaulted in the 1990s, the economic costs were in the end less than those of the countries that struggled to avoid default (e.g. the Russian Federation has gained investment grade while Colombia has not; Argentina is growing fast while Brazil faces inadequate growth rates).
2. Asymmetric relations between debtors and creditors: The mainstream view was that it was in each sovereign debtor's interest to maintain harmonious relations with its creditors, which meant they worked hard to avoid default. However, both theory and evidence actually indicate that striving to maintain a good debtor reputation through a crisis period is not an important factor for speeding the post-crisis return to market access. Also, once default is inevitable, large borrowers have different options than small ones that do not threaten creditor solvency. Divergence of interest between a debtor and its creditors and among creditors has to be taken into account in the search for solutions to debt crises.
3. Capital controls: Following the 1990s experience, IMF is less dogmatic in opposition to them, especially in a debt-crisis context; but isn't there a case for their broader use in crisis prevention?
4. Maintaining adequate financial flows during and after the crisis: While broadly accepted in theory, this is not exercised in practice. Issues that should be addressed include the supply of finance during crises (in particular, role of IMF) and the identification of mechanisms that would speed the country's return to the market, such as guarantees supplied by the international financial institutions (IFIs). IMF and the IFIs were designed to be "risk free" (e.g., the argument for conditionality is to ensure repayment capacity; IFIs enjoy absolute seniority in repayment), but is that what we need today in public international finance?

In the discussion, participants remarked that policies that addressed borrowers' moral hazard (e.g., policies that enforced repayment) could be considered as a public good, as they would lower the overall probability of default and thus risk premiums on loans. However, enforcement would mean punishing people, which itself has a social cost. In the past, governments imposed the cost through the debtors' prison for individuals or military intervention

for sovereigns. In today's world, the role of disciplinarian falls to the IMF and it has been tough ("not taking yes for an answer", meaning IMF toughens conditionality when the debtor offers to accept IMF medicine so as to signal to other debtors that future defaults will be more painful). But punishment for defaulting debtors does not allow for the resolution of the default, as capacity to repay is compromised through the punishment. It only works as an example for others not to default (ex ante incentive effect). Moreover, it is not clear that it makes sense for a country to absorb the economic costs of government policy to squeeze the economy to avoid default. Does it guarantee a good relationship with creditors? Defaulting countries have recovered and gone back to private creditors. Markets are forward looking (although economists have created a few peculiar models where bankruptcy determinants are backward looking).

On the other hand, some participants did not see IMF as consistently playing the role of enforcer, or wanting to impose maximum punishment, taking the case of Argentina as an example. One tempering argument on Argentina was that IMF got cold feet after having gotten it wrong twice: first supporting the Convertibility Plan after it became unsustainable; later by underestimating the country's capacity to grow under default. It was also suggested that as creditors could not seize debtors' assets in sovereign default, the only pain creditors could inflict on debtors was to delay the debt resolution and return to financial normalcy. Participants also suggested that costs for a given country (in terms of GDP contraction) did not exclusively originate in the default itself but also in the economic crisis that preceded the default (currency, banking and corporation crisis). The important question is whether the economic crisis is worsened by the difficulties and delay of the debt resolution. Finally, because default also has high costs for creditors, they would want to avoid or postpone it for as long as possible. Although Mexico, for instance, *de facto* defaulted on its debts in the 1980s, *de jure* default was never enacted as debt obligations were rolled forward in a series of concerted restructurings (and thus cross-default clauses were never applied).

Lessons of theory

Stiglitz, in his presentation, argued that a bankruptcy regime is an essential component of capitalism. Such regimes exist at country level, but today's globalized market needs a global regime. Many people argue that market-based mechanisms will suffice at international level, where there is anyway no global government comparable to national governments to enforce judgments. They argue for working through the content of contracts, although it can be observed that even in the United Kingdom, which has collective action clauses (CACs) in standard corporate bond contracts, a legal bankruptcy regime is still deemed necessary. Also, contracts usually do not bind non-signatories and thus do not solve the problem of aggregation across different types of debt instruments and creditors. Furthermore, legal frameworks emerged at the national level to set out and protect both majority and minority rights in a debt problem (every group seeks to protect its own interest, even at expense of the others). Judges are necessary in the face of the ingenuity of market participants to advance their individual interests. Indeed, much of the economics and law literature on bankruptcy looks at incentives of different actors and the interplay of their strategies, and how different bankruptcy regimes affect ex-ante efficiency or economic behavior before bankruptcy is called. Very little of this got into the sovereign bankruptcy discussions.

Moreover, as chapter 9 (for municipalities and other sub-sovereign public entities) of the United States bankruptcy code recognized, there are implicit contracts of a government with its

population as well as explicit contracts with creditors. In short, efficiency and equity concerns, coupled with the realization of the role of imperfect information and market imperfections in finance, argue for an explicit sovereign bankruptcy regime.

Stiglitz also dismissed the argument that a sovereign bankruptcy regime would necessarily favor debtors, encourage bankruptcy, and raise the cost and reduce the flow of funds to developing countries as a result. Even if it did, he would not mind if capital flows were less, as long as economic growth was not penalized. That is the question. Also, he worried less about creditor losses in debt restructuring when the high risk premiums they capture before default have already made them whole. Besides, the premium does not reward risk taking if the creditor does not actually risk taking the loss; in the case of Argentina, a lot of the debt is now held by speculators who bought at a steep discount, meaning others, not they, already took the losses.

Stiglitz was critical of the IMF-designed Sovereign Debt Restructuring Mechanism (SDRM) and would prefer to see an independent International Bankruptcy Organization, albeit recognizing it would not happen anytime soon. In the meantime, he called for: greater willingness to impose capital controls when a sovereign bankruptcy loomed; agreed mutual recognition of national bankruptcy laws and procedures to resolve conflicts in sovereign debt cases that go to court; and creation of an international bankruptcy evaluation/mediation service.

While the counter perspective was largely embodied in the presentation and discussion of Roubini (see below), it could be noted here that the perceived weakness of enforcing contracts on sovereigns might be overdrawn: while a creditor cannot attach the overseas assets of the government, it can capture payments to other bondholders once the government transfers the funds to the fiscal agent, who is not sovereign. This aside, there is still no answer to who enforces the judgment of an international bankruptcy organization. Stiglitz argued that his point is different: he wants to replace what theory and practice tells us is an inefficient and inequitable bargaining process with a focal point for dispute resolution on sovereign debt, which would entail at least the aggregation and mediation function of a bankruptcy regime.

How debt is restructured

Some of the authors had been asked to prepare papers on how different categories of external sovereign debt obligations have been restructured in workouts from debt crises. Different and independent mechanisms have arisen to deal with sovereign obligations to other governments (Paris Club), to foreign commercial banks (London clubs), and to holders of foreign currency government bonds (exchange offers under changing contractual terms). While these mechanisms set the expected terms for remaining defaulted private financing (e.g., suppliers' credits), there is no general mechanism for relief of debt owed to the multilaterals, who are "preferred creditors" and must be paid before all else. Only the poorest and most indebted governments are relieved of obligations to the latter, and then within the context of their relationship with the donor community.

Paris Club in historical context

Enrique Cosío-Pascal focused on the evolution of processes for restructuring bilateral intergovernmental debt servicing. Among the important benchmarks after the Second World War was the "bisque clause" in the Anglo-American Financial Agreement of 1946, which allowed the

United Kingdom to unilaterally postpone principal and interest payments if conditions warranted. He also described the Multilateral London Conference on the German External Debt of 1953, which granted deep relief in respect of the wartime damage to the economy and the priority for recovery. In the post-war years, governments continued to be involved in international lending to other governments both directly and through insurance of private export credits. When sovereign debt crises ensued, it required a collective creditor response, for which the Paris Club was created in the 1950s as an informal arrangement with rules agreed among the participating creditors. In the 1970s, debtor and creditor governments sought to draft agreed guidelines for renegotiating external sovereign debt, in particular at the Conference on International Economic Cooperation (“North-South Dialogue”) in Paris at mid-decade. No agreement was reached at that conference, but negotiations continued under the aegis of UNCTAD, where agreement on a set of guidelines was finally reached in 1980. Although implementation was not mandatory, this set of principles for debt restructuring was the only one ever agreed by consensus in a joint debtor/creditor forum and was viewed at the time as legitimizing the Paris Club within the international financial architecture.

This notwithstanding, the Paris Club treated crisis-country debt in the 1980s increasingly as part of the overall “short leash” of multilateral financial control of crisis countries undergoing structural adjustment. On rare occasions, deep-relief exceptions were made for politically important cases (Poland and Egypt in early 1990s). One can also trace the increasingly concessional terms the Paris Club offered to low-income debtor countries, culminating in the enhanced Initiative for the Heavily Indebted Poor Countries (HIPC), which introduced a mechanism for relief of debt owed to multilateral institutions. This implied a growing acknowledgement that debtors were not escaping insolvency. Adoption of the Evian Approach by the Paris Club in 2003 opens to non-HIPCs the possibility of addressing insolvency.

The discussion focused on country experiences at the Paris Club. Examples were given illustrating problems that have already arisen with the implementation of the Evian approach. Georgia had unsustainable debt but did not receive the necessary debt relief from the Paris Club, only a deferral of payments to the future. Because of the huge cuts being sought for political reasons and so as not to set a precedent, Iraq was unlikely to be treated under the Evian approach. The question was also raised as to whether HIPC creditors might have to give further debt relief. The process appears not to have brought about debt sustainability, as illustrated by the case of Bolivia. A prime reason, according to Cosío-Pascal, was that the HIPC Initiative does not reduce government expenditure by the amount of the debt-servicing reduction, but transfers it to social expenditure in domestic currency (and for countries receiving the standard 90 percent bilateral relief, 10 percent of former debt-servicing obligations have to be paid and in foreign currency). In other words, while relieving pressure on the external balance, the fiscal balance would be essentially unaffected. HIPCs thus needed additional international support, which should this time take the form of an actual debt write-off instead of a “disguised swap,” according to Cosío-Pascal.

There was also some discussion of a concern attributed to private creditors of governments that go to the Paris Club, namely that there should be comparability in the losses taken by private and official lenders. While in many cases Paris Club creditors just defer claims to the future and are willing to reconsider further rescheduling and relief in multiple future rounds, private creditors want to settle once and for all and may thus accept a “haircut” up front.

Dealing with commercial bank debt

Luis Jorge Garay reviewed the treatment of the sovereign debt crises in the 1980s in which foreign commercial banks had been the main creditors. Syndicated bank lending had arisen in the 1970s as a major vehicle for mobilizing a large amount of private finance for governments in a single operation. While funds could be provided by hundreds of banks in different creditor countries, a single bank or small group would organize the consortium and act as intermediary with the borrower. When a debtor government ran into difficulties, the leading banks of various syndicates would step forward and organize a committee (variously called a London Club or Bank Advisory Committee) to represent all the creditor banks, which in the end voted on the proposed restructuring by selecting from among a set of options negotiated by the committee or rejecting the proposal. The process delivered the requisite discipline on creditor banks for effective negotiation with the debtor in a case-by-case approach.

Garay reviewed how the restructuring agreements evolved from rescheduling of annual obligations on the assumption that the countries had only liquidity difficulties (1982-85), to multi-year rescheduling in recognition of the structural character of the debt crises, with more coerced additional bank financing to cover payments falling due (Baker Plan, 1985-1988), finally to resolution with explicit haircuts taken in the form of swaps of bank loans into bonds with lower present value, albeit with guarantees attached to reduce their risk for the creditors (Brady Plan, 1988-1994).

In the discussion that followed, participants focused on the relations between debtors and private creditors during the 1980s debt crisis. One question that Garay himself raised was why a debtors' cartel did not emerge despite discussion at the time of the value such a grouping might have. There were some minor attempts in that direction (e.g., exchange of information under the Cartagena Consensus). However, apparently, debtor governments often felt more confident as individual negotiators. In fact, this seems to be a continuing pattern, seen recently when the big debtors took the same view as their private creditors and preferred continuing under a market-based approach of individual country ad hoc negotiations, as opposed to a statutory approach under a common set of rules. They apparently felt they could do better without a new legal structure.

It was also noted that the Brady Plan actually did not provide most countries with net debt relief in part because participation entailed costs for the debtor countries. That is, the guarantees attached to the Brady bonds took the form of zero-coupon US Treasury bonds that were purchased with funds from new multilateral loans. On the other hand, the plan was useful for the commercial banks, which needed to clear non-performing assets from their portfolios.

The process for restructuring bonds

Nouriel Roubini stood in for Richard Portes and Daniel Cohen, and presented his own views, developed with Brad Setser, on how the method that has evolved for restructuring sovereign external bonds has been working. That method draws on the obligations of bondholders and the borrowing government as stipulated in the bond contracts and on practices that have evolved under the laws of contract in the major financial market countries. In this view, international policy reforms in the way bonds should be restructured would be reflected in changes in the standard terms of bond contracts. Indeed, Mitu Gulati presented research

undertaken with Stephen Choi on how the “boilerplate” terms of sovereign bond contracts have been changing and what seems to drive the changes.

Economic dimensions

Regarding the restructuring process as it operates today, Roubini argued that the system may be piecemeal, but it functions relatively well. The essence of the process is that after default, the government—on the advice of international investment banks and law firms—makes an offer to its bondholders to exchange the old non-performing bonds for new bonds worth less than the nominal value of the old ones. If the exchange offer is close to the discount from face value at which the old bonds are trading in the secondary market, large participation of creditors is almost always assured.

Roubini saw the main collective action problem as being before default, when creditors fear default and rush to sell the country’s bonds, lowering their price and raising their yield. This, in turn, raises the interest rate creditors demand on new short-term borrowing and rollovers of maturing debt. In fact, any debtor government can stop this rush by suspending payments (default). Litigation against the government is not a realistic threat as there are virtually no assets to attach. Besides, litigation is costly. As creditors understand this, their fear of default during a difficult period for a debtor can force it to happen. There thus needs to be a balance as far as the perceived costs of default are concerned; i.e., default should be possible but not painless. The major problem, in any event, was not how to handle default, but how to prevent it.

The discussion of Roubini’s presentation focused on the determinants of the cost of default. One argument is that it is worsened by periods of delay before it is resolved. Thus, an exchange offer on a take-it or leave-it basis may be more effective than a drawn out negotiation process. On the other hand, once in default, there may be less and less reason for the debtor to settle as time passes, as it is not paying, while building the level of debt through arrears. Ultimately, the pressure to settle may come more from the political side—to straighten out debtor-government relations with the Group of 7—than from returning to the market. Also, individual creditors holding defaulted debt are not going to lend again and so paying them a greater fraction of the face value of defaulted bonds does not gain the debtor anything; i.e., new funds from future bond issues would likely be supplied by different lenders.

Moreover, it was argued that market-based restructurings have not changed debt profiles very much. The market-based system works to perpetuate whatever equilibrium (or standard practice) gets established. An alternative framework, like a bankruptcy mechanism, might change the standard (expected) outcomes.

Others underlined one point of Roubini’s, namely that the cost of default depends less on the legal regime than on the crisis in the real economy of the debtor country (devaluation, banking crisis, etc). In particular, a significant interval between the realization by country policy makers that the debt situation is out of control and their default declaration worsens their eventual adjustment and repayment capacity. Also, the terms of debt restructuring that are viable depend on the size of the adjustment in the primary fiscal surplus that the country can sustain.

The process will be strengthened, albeit marginally in Roubini’s view, by the recent introduction of CACs into bond contracts drawn up under New York law to reduce the threat of

“holdouts”, which is when a small group of bondholders do not accept an exchange offer and hold out for full repayment. The process was also strengthened by the prospect of an agreed Code of Conduct to shape a cooperative approach to a workout by debtor sovereigns and their private creditors (see below on the proposed Code). However, even before CACs, Roubini did not feel that there was a serious holdout problem in general. Indeed, it is only possible for the defaulting government to satisfy a small number of such holdouts by fully paying them off and then it is only at the expense of a deeper haircut for the majority of creditors. In practice, Roubini said, exchange offers have been accepted by the large majority of creditors if they were reasonable.

The aggregation problem (wherein minority holders of a single issue could stop an exchange offer affecting multiple issues) has also not appeared to stop debt restructuring in practice. Roubini did, however, see room for additional contractual reform. The lack of a formal seniority structure for establishing priority in sovereign debt repayment under restructuring is a case in point, although there is already an implicit system of priority.

Legal dimensions

In fact, there has been quite a bit of interest in contractual reform in the international policy community for about a decade, in particular, regarding adding CACs to standard bond contracts where they did not already exist. Yet, not much happened until 2003. Gulati and Choi undertook to study why these contracts changed the way they did when they did. They found there was considerable inertia to overcome before the old standard of unanimous-consent New York law contracts began to change into contracts with CACs. The disturbance that provoked the change was the unexpected use of “exit consents” in Ecuador’s bond exchange offer in 2000, which effectively nullified the unanimous consent provisions of Ecuador’s bonds that the market assumed had made them restructuring proof. And yet it took three years for the contract changes to begin to appear and about a year after that for the new terms to become the new “boilerplate.” Clients of the largest law firms in the sovereign bond market led the changes, suggesting that there are economies of scale in advising multiple clients to make legal innovations, which need to overcome an acceptance hurdle before becoming the new standard.

In other words, as the discussion emphasized, there appears to be a built-in and deep institutional bias against change. The whole point of boilerplate contracts is that they are standardized and do not need to be read. Also, a few law firms dominate the sovereign bond market and can and do copy each other’s contract terms. Moreover, altering the terms of the contracts draws attention to them, and thus investors and rating agencies might begin to ask questions that could raise the cost of the prospective bond issue (meaning either the new terms were “wrong” or the old ones drawn up by the borrowers’ attorneys were “wrong” before). On the other hand, once change begins, issuer countries can push its pace to ensure that their contracts are as up-to-date as those drawn up for their competitors.

Finally, a question was posed about conditions under which contractual obligations in a bond might be overruled by other considerations. In particular, the doctrine of “odious debt” has been applied, albeit very infrequently, to free a debtor sovereign of having to service a debt that was declared “odious,” owing in essence to the anti-social purpose to which the borrower put the funds, which the lender knew or should have known about. It was said in response that while this doctrine has a strong moral appeal, it is difficult to set consistent principles for its application.

For example, Great Britain only honored Boer War debt incurred prior to the commencement of hostilities, while the United States insisted that Ethiopian debt incurred by its earlier regime be paid. Debt relief for countries in a state of need owing to insolvency is a more practical approach.

A question related to that of “odiousness” of debt was also mentioned, namely that some civil society advocates have argued that borrowing governments should not have to repay loans to the multilateral institutions made in support of policy actions that were required as conditionality for the loans, when the policies actually worsened the situation in the borrowing country or in other developing countries. The question here is not odiousness, however, as the intent was not odious, but instead asks what the proper risk sharing should be between the shareholders of the IFIs and the borrowing countries when the countries get bad advice (see also Ocampo point above on risk aversion by IFIs).

Taking stock of major reform proposals

The last several years have seen a number of major proposals to reshape the process for resolving sovereign debt crises. None of them have won consensus support, but yet they are interesting for attempting to address broadly held concerns about the adequacy of the current system. The paper by Patrick Bolton and David Skeel critiques the experience in developing the proposal that came closest to enactment, the SDRM, and proposes a variant that the authors argue would overcome its defects. Jürgen Kaiser then reviewed several other proposals that would entail systemic change if enacted. Finally, Barry Herman took stock of the discussion of instituting a Code of Conduct for debtors and creditors, a relatively mild reform that nevertheless became enmeshed in controversy.

Building on IMF’s 2002 statutory approach

Bolton and Skeel reviewed the SDRM that IMF proposed in 2002, and suggested how it might have been improved. The SDRM was a form of super-CAS, a majority voting procedure designed to solve coordination problems among the different creditors, including the holdout problem discussed earlier. It would have been voluntary in that it would have been up to the debtor government to start it in motion, but it would then have required private creditors to participate (however, if they rejected the final settlement, negotiations would revert to the old ad hoc processes). One attraction of the SDRM is it would have improved information given creditors about the distressed government. Originally, the proposal also contained a stay on litigation, but in the face of opposition instead adopted a “hotchpot” rule: if a renegade creditor succeeded in collecting on its claims, as from a court settlement, that amount would be deducted from its final settlement under the SDRM. The proposal also included a “Sovereign Debt Dispute Resolution Forum” (SDDRF), albeit of limited jurisdiction.

Bolton and Skeel criticized the IMF proposal for not being comprehensive enough; e.g., it did not cover domestic debt, claims of international organizations, “privileged” debt and official bilateral claims (Paris Club debt). Also in not retaining the stay on litigation, it lost a tool to bring creditors into a common forum, instead of leaving it open for them to try their luck in different courts. In addition, being institutionally close to IMF compromised the independence of the SDDRF, and it did not distinguish creditors by priority, lumping them essentially into a common pool, outside of privileged claims. Indeed, unlike restructurings under corporate

bankruptcy law, it would have been difficult to arrange debtor-in-possession (DIP) financing by banks or other private lenders; i.e., DIP creditors are given absolute priority in repayment in corporate cases, whereas new private lending to the defaulted sovereign would have the same status as already defaulted credits and thus dilute all their claims. Thus, only multilateral lending, which automatically has absolute repayment priority, would be feasible.

In the view of Bolton and Skeel, these shortcomings could be overcome in a revised proposal. They thus suggested that distinctions among categories of debt could be handled by having a two-step vote on a restructuring. First, there would be a global creditor vote on an overall relief package and then holders of each bond issue would vote on their own haircut. The second vote could invoke a “cramdown” by the overall majority on recalcitrant minority creditors, as in corporate cases. In addition, in their view the role of IMF in the mechanism needed to be reduced, as it has conflicting interests. Instead of being IMF-centered, the new SDRM could prearrange to operate under the bankruptcy courts of major financial centers (US, UK, Japan, Germany).

A number of skeptical questions were raised in discussing the new proposal. While, setting priorities among different classes of creditors could help reach a restructuring package, could prioritization of creditors for repayment be obtained instead through a market-oriented reform? Secured versus unsecured debt already establishes a priority ranking. This aside, decisions on subordination of one type of debt repayment to another require enforceable structures and thus a framework like SDRM. It was also noted that the IMF Executive Board would lose its role in approving the debtor government’s economic adjustment program in the revised proposal, as the creditors would determine by vote what would be the size of overall relief package (and thus the financing gap). The authors fully understood this. The role of the judge assigned to a case under their proposal gains importance and would mirror key elements of the role of the judge under US Chapter 11, which governs the attempt to reorganize bankrupt corporations. Finally, it was asked if this would differ from forceful and efficient mediation between the sovereign and its creditors.

Alternative debt resolution mechanisms

Kaiser described six proposals for more ordered debt workouts. They were put forward by the IMF itself, by members of the US and European legal profession, and in the case of the last two proposals, by civil society organizations:

1. IMF had proposed the SDRM, as discussed above by Bolton and Skeel, the core of which was how different classes of creditors would reach agreement with the debtor within an overall structure.
2. Richard Gitlin (Gitlin & Co.) proposed a Sovereign Debt Forum (SDF), which would be a standing independent body (private, non-profit) to advance sovereign debt as an asset class. One part of the SDF would be a debt-restructuring forum, on which a debtor government and its private creditors could draw on a voluntary basis. A set of best practices for sovereign debt renegotiations would be collected and a mediation service would be made available to facilitate debt restructuring.
3. Christoph Paulus (Humboldt University) proposed there be a model law for sovereign

bankruptcy, which could be drafted by UNCITRAL (the UN Commission on International Trade Law) or another suitable UN institution. The model law would harmonize thinking on sovereign insolvency into a worldwide set of principles that debtor governments could adopt into domestic legislation. In application to individual cases, an international panel of “arbiters” (judges) would oversee the process.

4. Return to ad hoc mediation was another proposal. The mediator would have no legal status beyond the voluntary acceptance by the parties of his or her facilitation. Kaiser cited the mediation of Indonesia’s debt in the 1960s by Herman Abs from Germany as a most successful case in point.
5. Jubilee Germany (erlassjahr.de) promotes a Fair and Transparent (ad hoc) Arbitration Procedure (FTAP), as conceived by Kunibert Raffer (University of Vienna). FTAP would protect the sovereign sphere of the debtor so it could provide for the minimum needs of the population and organize the seniority of claims against it. It would provide for independent assessment and decision-making on the debt restructuring through an ad-hoc panel, with equal numbers of members nominated by the government and its creditors and with an additional person nominated by the arbiters.
6. Non-governmental organizations in the South proposed an International Insolvency Court, with binding decision making power on any issue of international capital flows, based on international law. The court would either be established within the UN system or with the International Chamber of Commerce (as proposed by Latin American economists Alberto Acosta and Oscar Ungarteche) or at the International Court of Justice (as proposed by AFRODAD in Harare).

Kaiser concluded by calling for a comprehensive approach that can deal with all the claims against the debtor in a single procedure without disruptions between creditor groups and with impartiality of decision-making. He especially criticized the IMF’s proposed SDDRF, which would have consisted of members from a pre-defined pool established by the IMF Managing Director. Moreover, it was most important in his view to have an independent assessment of debt sustainability. The aim must be to provide a reliable ex-ante framework for the resolution of debt crises, minimize unavoidable losses to creditors and investors, and secure fair burden sharing between sovereign debtors and their creditors.

One focus of the ensuing discussion was on the legal status of sovereign insolvency and the role of IMF. Kaiser noted that the IMF proposal would have been legally enforceable (at least on private creditors), as it was to be enacted through an amendment of the IMF’s Articles of Agreement. Also, the IMF put itself in the center of the debt restructuring mechanism. The Paris Club took itself out of the SDRM, leaving only private creditors. Other creditors wanted the IMF to be put out of its central role. It was argued that it actually is not in IMF interest to adequately relieve debt because continuing difficulty maximizes IMF’s bargaining power over the indebted government.

IMF staff had monopolized the debate when SDRM was being considered. Although it organized and listened to comments on its proposal, IMF itself amended the SDRM and in such a way as to bring forward more criticism in each cycle, instead of building a widening

constituency for it. Kaiser argued that we need a renewed discussion about an appropriate framework. Here the UN could facilitate a more comprehensive and inclusive discussion process.

One question was what rules would guide the mediators and arbitrators in the various proposals listed. Kaiser said that they would build up a set of precedents. It was said that the private sector needed predictability to lend. Therefore an arbitration or mediation process without rules to start would not be acceptable.

It was also claimed that an independent sovereign debt mechanism could be a forum in which to address the question of “odious debt”, a topic raised earlier in the day. The legitimacy of the debtor’s status as well as of creditor claims could be examined. There is already a legal literature on odious debt, and detailed criteria are defined. On such a basis, the debt that was found odious could be subtracted before the debt restructuring process started. However, the case of Nicaragua was mentioned, where the government decided not to appeal to the doctrine of odious debt. In other words, debtor governments themselves may find it a difficult proposition.

Concern about the adequacy of the debt sustainability analysis was an underlying motivation of some of the proposals. It was argued that debt sustainability is about balance sheets and has to be seen as a stochastic concept. Debt managers often extrapolate without looking at variances and without simulation exercises. Other voices said that the issue is not centrally about closing a technical analysis gap. Debt managers only see the short-term. Even political decisions are unfortunately often based on short-term analysis. What we need are long-term analyses and an appropriate definition of debt sustainability.

Who could prepare alternative debt sustainability analyses? Credit rating agencies were not an alternative. Kaiser reported that the Jubilee campaigns see more of a role possible for the UN. Other participants saw a need for further discussion about this issue. Kaiser concluded that achievement of the Millennium Development Goals and the necessary social expenditure should be taken into the concept of debt sustainability. Therefore, case-by-case assessment of debt sustainability would be better than a single financial concept and corresponding quantitative indicator being applied to different countries.

A Code of Conduct

Herman outlined a paper he would prepare on the proposal to fashion a Code of Conduct for guiding the behavior of a sovereign debtor and its creditors when seeking to restructure defaulted external debt. The proposal to create such a code emerged in the aftermath of the financial crises of the late 1990s, when “involvement of the private sector” in crisis resolution (diplomatic code for no more bailouts) became international policy. However, discussion of draft codes of good behavior took off when they were presented as a “market-based” alternative to the active consideration of the SDRM. By early 2003, private sector institutions and individuals had made various proposals, joined by the Banque de France, whose proposal also contained a mediation option. The first drafting discussions involving any debtor country governments began in 2004 under the Group of 20, which was supposed to table a text in September. It was not agreed and the target was moved to December, although there seemed to be considerable

differences of views within the limited group holding the discussions.⁵ There has been no dialogue in a more representative forum.

Herman asked what would happen if a code emerged from such discussions? Would it be endorsed or recommended to governments and private creditors, say, by IMF? Would it become a template for differentiated individual debtor government agreements with groups of creditors? Despite being voluntary, would it creep into IMF conditionality? He recalled how good marks on adherence to an agreed set of voluntary standards and codes on financial and macroeconomic policy became a condition for eligibility for the IMF's Contingent Credit Line (which no country made use of). Would it become the "litmus test" for showing "cooperation with creditors" required for IMF lending to countries in arrears to those creditors? Would it somehow bind private creditor groups; i.e., would it be "voluntary" or "operational" in legal terms? Who would monitor and revise it? In short, would the code take on a quasi-statutory nature, substituting for the SDRM, or would it be an exercise in public relations?

In the discussion, the link of the code and the new CACs was stressed. The private sector saw the code as a venue for debtors to make stronger commitments of engagement with creditors and provision of information to them. But "buy-side" bond investors were dissenting over the code being drafted. They were concerned about wording on the use of exit consents, whether the debtor would pay the expenses of the creditor committees that would be set up to renegotiate the terms of defaulted bonds, and the kinds of commitments by the debtors to engage with the creditors. In particular, they saw nothing in the code that would force a debtor to come to the negotiating table. Overall, there existed a feeling among the buy-side that the code of conduct would be less robust from their perspective than current market practices.

There was some discussion about the degree to which such a code of conduct would in practice be voluntary. Concerns were expressed about enforcement on both creditor and debtor side. In certain countries, such as the United States, the possibility exists that in certain formulations it could bind those who sign it in the sense of making them vulnerable in civil suits. In addition, the US private market is aware that industry "best practices" can become government regulation, and so any proposed self-regulatory measures are "carefully scrubbed" because the regulators are watching. Moreover, the morbid fear of litigation in the US market makes it generally allergic to codes of conduct, whereas the Europeans are more comfortable with them (it was said there are more rules on the books in Europe than the US, but less enforcement). Thus, the US private sector would press to make the code as anodyne as possible, and meanwhile there was no longer any sense of urgency (i.e., the pressure for self-regulation is usually fear of official intervention and the SDRM had been killed). In any event, no one expected it to be relevant to the case of Argentina.

⁵ Post-meeting note: only two of the original 7 private-sector organizations remained through the end of the exercise, i.e., the Institute of International Finance (IIF) and the International Primary Market Association. They agreed on a set of "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" with Brazil, Mexico, Republic of Korea and Turkey. The finance ministers and central bank governors of the Group of 20 "welcomed" the principles ("which we generally support") as a good basis for enhancing predictability of crisis management "now, and as they develop in future" (Communiqué, Berlin, November 21, 2004). The principles can be found at www.iif.com/data/public/principles_1104.pdf.

How much external debt is too much?

The frequency of debt crises seems to have raised concern that developing and transition economies are too often left excessively vulnerable to crises. Partly this reflects concern about inadequate debt relief in workouts that are supposed to give crisis countries a “fresh start” but actually leave them with an excessive burden down the road, requiring serial relief exercises. Benu Schneider argues this case for Paris Club relief, especially for its treatment of poor countries. The vulnerability to debt crises has also raised concerns about borrowing choices by governments in a highly volatile international economy. In debt crises generally, lenders as well as borrowers have misperceived the risks or discounted them. In the case of low-income countries with debt problems, aid-providing official partners extended more credit than the borrower could handle which the lenders then had to reschedule or forgive. Henry Northover looks at the nexus of relations between official donors/creditors and aid recipient governments and how it shapes the form of financial transfers as grants, loans or relief. More generally, middle as well as low-income countries are increasingly concerned about the sustainability of their external debt. Stijn Claessens takes stock of the opportunities for better managing the risk embodied in that debt and how to improve upon them.

Paris Club debt restructuring and post-crisis sustainability

Schneider stressed the underlying problem in the functioning of the Paris Club: it is an informal “debt collection agency.” By design, it was set out to be an instrument of international cooperation intended to lead to the avoidance of a default. However, in recent years it has increasingly been assigned a role in development assistance through debt relief by creditor governments. In general, the Paris Club tries to avoid taking credit losses, preferring rescheduling to reducing the stock of debt. The stock of debt has only been reduced for HIPC countries and a few highly politicized cases. In some cases, the debt-servicing relief the Paris Club accords more or less matches the debtor’s previous annual growth in arrears and so the net cash flow benefit for the country can be quite small

Schneider focused on the problem of serial rescheduling for many of the countries coming to the Paris Club and was of the view that the problem reflects a gap in financial architecture. In cases when solvency problems are treated like liquidity ones, the original problem is compounded because of short consolidation periods and old cut-off dates, as well as mistakes in projections of the IMF and “snowballing” debt because of bunching of repayments due to relatively long grace periods, market interest on non-ODA rescheduled amounts and new credits after rescheduling. In this regard, the “short leash” approach (noted earlier) not only means debtor governments require serial rescheduling at the Paris Club, but they also do not move the country towards a sustainable debt level.

Moreover, she argued that many countries coming to the Paris Club for “flow relief” to address a liquidity crisis would be better off if the liquidity problem was dealt with by the IMF. That is, a liquidity crisis means the debtor country is able to service its obligations in the long run but not the short run, and so the Paris Club agrees to reschedule the loans, and the bilateral agreements implementing the Paris Club agreement usually include market interest rates on the rescheduled non-ODA amounts. The debtor country has to first negotiate the overall terms in the Paris Club and then complete a full set of implementing negotiations with each individual country member of the Club. As an IMF policy adjustment agreement is a precondition for the

Paris Club arrangement, there would be substantial cost savings to debtor governments and bilateral creditor agencies if IMF instead made its loans large enough to deal with the liquidity problem. In recent years Paris Club debt relief from payments for some years is increasingly being used to fund an IMF Program. If this changed, the Paris Club could then become a forum only for debt relief designed for insolvent countries where the period of the IMF program and Paris Club debt relief would be tailored to the specific requirements of the country.

In this event, the practical analysis of debt sustainability would become highly important, heightening the need to critically assess the current approaches to assessing debt sustainability. Already, the new Evian Approach to Paris Club arrangements for non-HIPCs seeks to explicitly distinguish solvency from liquidity problems, and thus hinges on the assessment of debt sustainability. In the first instance, the IMF is to provide that assessment. The present IMF approach is geared towards gaining additional resources through debt relief for an IMF program. Sustainability assessments are based on the premise that debt is sustainable if the borrower is able to continue servicing the debt and that an unsustainable debt is associated with continuously rising debt ratios over time. Schneider pointed out that there is evidence that debt can be unsustainable also at stable debt ratios over time. Moreover, the analytical work at IMF and the World Bank on sustainability indicators for low-income countries is at an early stage and needs clarity on what the Fund and the Bank consider as sustainable debt. In addition, preliminary results examining financial market views of the impact of a Paris Club rescheduling showed that it negatively affects spreads and some components of access to private finance.

Concern about Bretton Woods' debt-sustainability analysis was echoed in the discussion. One question was why does IMF not call for more relief in its assessments? The answer at the technical level was that economic forecasts were regularly over-optimistic, leaving countries with excessive foreign debt. But another view was to say the IMF "could not be that stupid" (i.e., make systematically biased forecasts). It made more sense to see decisions about the content and funding of IMF programs and debt relief as political processes, reflecting donor/creditor preferences and the short-leash strategy for maintaining control. It was not hard to see that developing countries needed their own capacity (and in the short-run, independent analyses) to produce national debt-sustainability assessments.

Another part of the discussion focused on how the Paris Club operates. For example, the Club has adopted various principles to limit relief, such as fixing a "cut-off date" (typically done in the debtor's first trip to the Club) and only treating debt incurred before that date. The political nature of the Paris Club was also highlighted; i.e., the degree of relief granted a country reflects political support (aside from well known individual cases, it was said that Francophone African countries received deeper relief). The Club has also been accused of not being transparent, in particular when private creditors were also expected to negotiate debt relief and the Club sought to shift more of the burden onto them. However, of late, there has been increased cooperation and sharing of information between the two sets of parties. Regarding Schneider's proposal for IMF to handle a liquidity crises alone without coming to the Paris Club for debt relief, it was noted that there is already a practice of bilateral agencies providing debt relief and capital to pay off arrears to multilateral financial institutions, so why not the reverse?

Debt and the aid relationship

As Northover could not be present at the meeting, Herman presented his main points for discussion, as per his outline. Northover's paper relates to developing countries that are dependent on aid, wherein debt is mainly owed to donors and official creditors. In his view and that of most of the Jubilee 2000 movement, debt sustainability analysis should include human development and social justice considerations and not just financial aspects. While this is a general principle, it is most directly applicable to aid-dependent countries where donors have committed themselves to the same concerns. In other words, Northover sees a compelling case for a closer integration of debt sustainability analysis, sustainability thresholds and forward financing strategies on the one hand with the need to mobilize the financing to reach the internationally agreed objectives of the Millennium Development Goals by 2015 on the other hand. He argues that debt relief for poor countries is another form of aid and should be judged against the Guidelines on Development Assistance of the Organization for Economic Cooperation and Development.

Northover argues that cancellation of debt servicing payments serves de facto as direct budget support in the form of grants. He sees potential advantages of this form of resource transfer compared to other channels for providing aid. Thus, while donor deliveries of assistance are subject to varying political and project timetables, debt relief can be committed long term and be highly predictable. Also, while donors urge themselves in their guidelines to focus on poverty eradication and economic growth, aid may fall subject to other foreign policy objectives; however, the aid-receiving country is free to devote all the resources freed by debt relief to these purposes. Thus, resources freed through debt relief could be allocated without external hindrance according to human development criteria with a greater impact on poverty reduction. Moreover, instead of switching expenditures completely from debt servicing to other spending, the government could reduce fiscal pressure and the risk of crowding out of private sector borrowing.

Some participants offered a different perspective, saying these views assumed debtor governments actually serviced their debt before receiving relief. Instead, they said most of them incurred arrears or donors were already covering their debt servicing with aid that might disappear with the debt-servicing obligations. In this view, the HIPC Initiative was really about accounting and did not deliver fresh money. Indeed, there was a fear that debt relief could be followed by less aid. Also, given that official debt relief is accounted as aid, a donor country's aid statistic could rise and the net financial transfer fall. Furthermore, when donors have to use aid for debt relief, they cannot use it for the activities they want to support, whereas explicit aid allows selectivity. This is an argument, however, against classifying debt relief as aid, not against debt relief.

It was also argued that not all debt relief is predictable as a form of resource flow, in particular, when donors opt for long-term flow reduction, requiring annual implementation arrangements, instead of stock reduction; i.e., actual delivery of debt relief in each year depends on donors' decisions, which, in turn, depend on the degree to which countries follow donor policy recommendations. The amount of relief also depends on international economic conditions, in particular, on the exchange rate at the time of the annual annulment of debt-servicing obligations. Finally, it was observed that there is herding behavior of donors, as there

was of private creditors during the Asian financial crisis; i.e., there are fads and spurts of debt relief action.

In concluding, Herman noted that Northover's outline dealt with disparate issues: integrating the MDGs into considering whether debt relief measures were adequate for aid-dependent countries (and in this way challenging the Bretton Woods concept of debt sustainability), and comparing debt relief as a financial flow with other aid transfer modalities. The latter was obviously complicated, as concerns raised in the discussion illustrated, while the former seemed very much a reflection of donor politics on debt sustainability.

Managing the risk of sovereign debt

Claessens' starting observation was how little risk management developing country governments actually do. He suggested this could result from a combination of perverse incentives, not having access to appropriate risk management tools, and not having the capacity in governments to use the ones to which they did enjoy access. The incentive question is the matter of political horizons that are short-term, and moral hazard on the expectation of a bailout. There is also a question of excessive risk taking by private borrowers, a moral hazard linked to the assumption of government takeover of obligations in a crisis, as has often been the case with banks. In reality, however, international "rescues" from sovereign (and nationalized private) default have been costly and inefficient and not a sensible approach to managing risk. In this context, he warned that governments should not take on too much private risk (e.g., explicit or implicit guarantees), but should instead create greater incentives for private risk management.

Some official financing is available to help deal with shocks that are a source of risk, but they are ex post and cumbersome (e.g., IMF Compensatory Financing Facility and European Union "Flex"). Derivative instruments in financial markets that developing countries can access are generally too short-dated to meet sovereign risk management needs; in addition, these are generally for risk of price fluctuations, when these countries also need protection against quantity surprises (although there are limited forms of disaster insurance). Redesign of debt instruments to share risk with external lenders has been discussed more recently; however, there is limited evidence of market interest, for example, in GDP-linked bonds. Countries that can afford it are self-insuring through large-scale reserve accumulation, but this is not economically efficient.

More generally, there is a market failure explanation for the inadequate supply of risk-mitigation instruments: the gains from improved risk management would accrue to the market as a whole and individual clients would not be willing to pay for a benefit they could not capture for themselves. This is to say there is a public good role for the official international institutions through involvement in new instruments, especially for low-income countries. Also, the institutions could help by issuing indices in which the market would have confidence (guaranteed free of manipulation), such as for commodities, which could be the basis for market-issued hedging instruments.

One question raised in the discussion was whether it would be appropriate to encourage risk-mitigating instruments in the financial markets in all cases. Some commodity markets have strong information asymmetries, as they are quite concentrated, like cocoa, where a few traders possess more information than other agents and policy makers. In addition, there is already a rather disappointing history of multilateral effort to intervene in this area. In particular, the

World Bank has had a difficult experience in trying to foster commodity risk-management tools. While this was partly for reasons internal to Bank management, the obvious developing country counterparty for an international financial markets hedging instrument, namely government commodity boards, have been largely closed down by structural adjustment policies. Indeed, small-scale farmers are not potential clients for standard market-based crop insurance schemes. There is also a problem in the culture in the World Bank and other institutions against taking on risk themselves, which militates against developing risk-mitigating loan instruments of their own.

Regarding the traditional role of compensatory financing, it was asked if actual multilateral lending was counter-cyclical or pro-cyclical (in particular in light of lags in disbursement). While the intention is counter-cyclical, some participants argued that, if one stripped out IMF packages to countries in severe distress, the remainder of IMF lending was pro-cyclical. Finally, while it is easy to call for better risk management by developing country governments, a pre-condition is to strengthen the back offices that provide the basic data for debt management.

Case studies

In addition to the policy papers discussed above, the editors sought to round out the discussion through a selection of individual country case studies, highlighting various aspects of the sovereign debt issue. Following are reviews of cases that are being prepared. An additional case for an African country had still to be commissioned.

Argentina: Default and an external debt restructuring strategy

Roberto Frenkel argued that the 2001 default has been positive for Argentina, as the post-default period coincided with a period of fast growth in the economy, albeit after a very deep depression. Two thirds of the 20 per cent contraction in GDP happened before default, mostly associated with the difficulties brought by the failing convertibility regime. Since default, however, total debt of the government increased from \$114.5 billion or 43 per cent of GDP in December 2001 to \$178.8 billion or 147 per cent of GDP two years later. Much of this increase was due to bonds issued in relation to the “pesification” of dollar assets held by banks. External debt is at \$110 billion: \$30 billion owed to the multilateral institutions and being serviced; \$80 billion owed to private creditors and currently in default. Argentina proposes to deal with the private debt through a series of bond swaps that would reduce the debt by about 75 per cent. This haircut would lead to a situation in which Argentina would not need any net external private borrowing for many years to come, assuming it can maintain a primary budget surplus of around 3 per cent of GDP and an average rate of growth of the economy of 3 percent per year.

Participants questioned the viability of the proposed Argentine debt swap, as there were no “exit consents” or other instruments in the proposal to deal with potential holdouts. Also, creditors got a temporary US court ruling that delayed a rather debtor-friendly restructuring of bonds by the Argentine Province of Mendoza, signaling that creditors might successfully fight such swaps, although the ruling was subsequently lifted. On the other hand, it was argued that there would be pressure on foreign creditors to settle from direct foreign investors whose investments were performing in Argentina. That is, they could fear that a failed debt-exchange offer or one that did not restructure the foreign debt in a satisfactory way for the country would

raise Argentine public opinion against foreign capital in general. In fact, as domestic pension funds already accepted the deal offered by the government, the pressure on external creditors has increased and it was expected that at least some 60 to 75 per cent of them would take the offer, thus making it a success.

In a broader context, it was stressed that such success—if realized—would have never been possible under a comprehensive SDRM, as official creditors would have had to be involved as well. Others argued that the cost of default for the sovereign was largely independent of the legal regime, the reality being that any sovereign debtor could suspend payments whatever the regime being applied (CACs or SDRM). Furthermore, the “take it or leave it regime” of exchange offers has worked in resolving crises. An opposing view is that the question is not just does the debt get restructured, but does it solve the economic problem. Speed and equity are other considerations to take into account. It was suggested that differences between “statutory” and “market-based” regimes had been perhaps exaggerated and actual outcomes in the market-based approach may have been influenced by the rise and fall of discussions of instituting the statutory approach. It was also suggested that the framework does not determine the outcome. There were three different outcomes from the same framework in the cases of Ecuador, Russian Federation and Ukraine. Indeed, it was further claimed that the market solution led to unstable dynamics and thus did not bring lasting solutions to the debt problem or prevent new crisis. It only constituted a repetitive series of games.

Turning to another general issue, generating or increasing the primary surplus as part of the adjustment program, it was mentioned that this usually required depressing economic growth at a time of economic distress. Alternatively, one could go the markets and borrow to meet the interest payments. But in that case, authorities had to consider whether these funds would generate a return higher than their cost. One also had to consider that, for example in sterilized borrowing, the internal transfer (from private to public) could be more costly than the external transfer, owing to higher domestic than foreign interest rates.

Indonesia: too much domestic sovereign debt in the aftermath of a banking crisis

Iwan Azis presented a long-term perspective on Indonesia’s sovereign debt management from the 1960s through the time of the financial crisis in 1997 and its resolution. The main concern today is a worrisome level of domestic government debt, which is largely the result of rescuing the banking system (cost estimated at 50 per cent of the country’s GDP). Domestic debt servicing absorbs almost half of total government revenues. Despite the restructuring already undertaken in 2003, domestic debt is still unsustainable. External government debt has been better managed.

Indonesia has experienced external debt crisis, notably in the 1960s. Major donors had wanted to assist the post-Sukarno government but that required loans and they thus first had to resolve the debt problem. Once this was done through the Paris Club, the donors formed the Inter-Governmental Group on Indonesia (IGGI), which not only was a forum to coordinate foreign official assistance, but also to monitor Indonesian external debt, most of which was concessional official borrowing. In the 1970s, however, Pertamina, the state-owned oil company borrowed aggressively and when it defaulted in 1975, the central bank took over its obligations. The government then imposed strict controls on public enterprise borrowing and brought them within the IGGI purview. IGGI was itself disbanded in 1992, after its founder, the Netherlands,

and two other countries suspended their loans to Indonesia to protest the shooting of demonstrators in East Timor. However, the Consultative Group on Indonesia (including Japan, the World Bank and the Asian Development Bank) was formed to replace it and there was no major change in external debt policy, according to Azis.

The discussion focused on how to resolve the excessive domestic debt situation. The government had initiated a buy-back scheme for bonds held by banks and securities companies, using some of the proceeds from privatization. Indeed, one concern of the government had been that the banks had been content to hold the government bonds received when they were recapitalized to clear their bad debts, and collect the interest on them instead of expanding lending to the private sector. The government also unilaterally “reprofiled” bonds held by banks still under government control to stretch out repayments and it has developed other proposals. It was suggested that a possible solution would be not to pay the banks by using additional swaps into bonds with longer maturity and haircuts. One would need to assess the implications of such a concerted measure in terms of continuing to meet Basel capital adequacy standards and evaluate how much further public cash injections would be necessary to maintain the banks’ viability.

Moldova: Bad advice, management and negotiation

Shari Spiegel described how the Moldovan economy collapsed following the dissolution of the Soviet Union, while accumulating an external sovereign debt that went from zero in 1991 to 127 percent of GDP by 1999. Up to 1997, the debt was mostly accounted for by official loans and arrears to Russia for energy imports. Moldova failed to meet IMF fiscal targets in 1997, which cut off IMF funding. It replaced those resources with a five-year Eurobond to fund its deficit and repay IMF. In 1998, following Russia, it devalued and foreign debt doubled in domestic currency terms. By 2002, when Spiegel and Stiglitz visited Moldova, 75 percent of public revenue was being used to service the foreign debt.

Initially, Moldova had been judged a middle-income country, but with the fall in output and with a more realistic estimate of GDP, it qualified for IDA lending in 1997. It nevertheless had built up expensive obligations, as to IMF, which it serviced fully. Obligations to Russia were rescheduled in 2000 and the Eurobond was later rolled over into a 7-year bond with no haircut, albeit a lower interest rate (6.4 percent, down from 9.875 percent).

In Spiegel’s view, Moldova’s government made several poor choices regarding its external debt. First, Moldova bought back part of its Eurobond, which was trading at a discount, thinking that the purchase would signal the haircut that the Paris Club should give under the principle of comparability. However a buy-back does not count as restructuring. Second, in her view, they should have negotiated a better deal when restructuring the Eurobond. (She also said there would have been no collective action problem in renegotiation, as the outstanding bonds were all held by a single bondholder). The cost of default has to be weighed against the cost of not defaulting. Default in this case would not necessarily have been costly. In fact Moldova was a net “creditor” to the rest of the world, in the sense that more funds were flowing out of the country to service foreign debt than foreign funds were flowing into the country. After the 1998 devaluation, Moldova was seen as a poor credit risk and had no further access to the market, so there was virtually nothing to lose. But, policy makers feared default would discourage direct foreign investors, although they had few to speak of. Those that had invested had mostly come

from Russia and were said to be less concerned about Euromarket reputation. In fact, while not defaulting on their hard currency obligations, the government did default on domestic social security and wage payments, and payments to Russia. In short, as Spiegel said, the government's fear of hurting its international reputation by defaulting was irrational but very real.

Finally, Spiegel thought that Moldova's initial ability to float a bond issue was itself a signal of the poor quality of due diligence by Euromarket creditors. Bond buyers or their advisors were not properly screening credits. The point was accepted in the discussion as a characterization of the market before 1998, but one participant argued that this was no longer the case, although there was disagreement on this point.

The Russian Federation: from financial pariah to star performer

Sergei Gorbunov focused on the evolution of Russian debt since the break down of the Soviet Union, the events leading to sovereign default in 1998, and how Russia rose to be a "star performer" among sovereign debtors. The central weaknesses had been the heavy economic burden of an overvalued exchange rate, which had been hidden by the oil export sector, and the desperate need for fiscal reform. Before devaluation, virtually no industry could compete with imports except petroleum. To underline this, Gorbunov noted that it was cheaper to import potatoes, the Russian staple, from Poland rather than buy domestic ones. The economy began to recover after the devaluation in 1998, as did tax revenues, but also an important political decision was made to fix the fiscal system. This included imposition of an *ad valorem* tax on oil exports in 1999, which Gorbunov said government officials had literally been afraid to do earlier. In addition, the government has established a fiscal stabilization fund with oil tax revenues and it has paid down debt, seeking a relatively low debt indicator in light of the international instability it faces as a commodity exporter.

Debt repayments included advance payments to IMF to bring its position in the Fund low enough to relieve it of post-program monitoring. Indeed, participants commented on the less-than-successful role of the IMF in the Russian crisis and on investors' pre-crisis behavior. In Russia (as in Argentina, above), postponing devaluation was very costly. In this case, it raised external debt by 50 percent in less than one year.

A great deal of the discussion focused on financial aspects of the default. To start, only specific portions of the Russian debt were put into default: those originated in the Soviet era and debt issued in the domestic market under Russian law. External Russian debt that was contracted after 1992 continued to be serviced. It was suggested that Russian authorities had alternatives to defaulting on their domestic debt, e.g., they could have reduced the effective burden on the budget by allowing inflation to rise, with guarantees to maintain the real value of small deposits (e.g., by indexing them) to protect the limited assets of the poor. It was suggested that it would be interesting to examine in greater detail the reasons the Russian authorities chose to honor some classes of debt and not others. The broad answer to why not inflate away the debt was the very negative experience with inflation in the early 1990s, which would have had adverse consequences for the government had it returned. In addition, there was a tradition of paying—and honoring the debt would be politically supported domestically—to maintain some credibility, at least on the obligations of the Russian Federation as opposed to those of the ex-

USSR. Other influences were said to be a sense of responsibility that came with being a member of the Group of 8, and the desire not to raise obstacles to being able to collect on foreign debt owed to Russia. Finally, it was pointed out that Russia defaulted on debt under domestic law, but did not default on debt under international law. It was suggested that had there been a different international financial architecture, say, an SDRM, it could have made it more likely for Russia to restructure its external obligations overall, including the Eurobonds it serviced and not go for a selective approach.

Participants also discussed the securitization into the market in 2004 of some of Russia's rescheduled Paris Club debt owed to the German government, and its implications for risk sharing between private investors and (in this case, German) taxpayers. This was an expensive operation for Germany in terms of net interest flows, but it was done to meet Germany's commitments under the Stability and Growth Pact of the European Union (i.e., by securitizing Russian obligations, Germany was able to raise revenues for its budget without raising its own nominal public debt level). In addition, the operation raised the potential cost of Russian borrowing from the market, as Germany has added to the total stock of market-held Russian debt, for which there is a limited demand. While this would not harm the Russian government, which is repaying its foreign debt on a net basis, the German action could have raised private Russian borrowing costs. In sum, this policy was not good for Germany or Russia. Moreover, there is a broader issue: if through such operations a creditor government shifts part of the risk of non-payment on restructured Paris Club loans to private investors, the underlying principle of the Paris Club itself is challenged; i.e., each creditor's share of Paris Club debt should correspond to its share of Paris Club risk.

Conclusions for authors and editors

There was a general sense that the papers and the discussion in the meeting had covered the major questions on sovereign external debt, although some participants recommended additional work. One suggestion was to give more attention to the issue of odious debt: e.g., how to define it? The basic question with odious debt is whether the origin and nature of the loans should affect their treatment in a debt crisis (or free debtors from servicing such debt even when not in a crisis situation). This point was raised in the context of saying that sovereign debt should be analyzed from the broadest perspective possible, encompassing economic, legal, philosophical and moral aspects. One proposal was to commission a separate chapter on this issue. A counterproposal was that the issue could be woven into existing papers.

Another issue that was said to require additional attention was the political economy of borrowing, lending and servicing debt. What are the incentives for sovereign debtors to service their debt? What determines the magnitude of debt relief? Why do donors give money? Why did middle-income countries oppose the SRDM? Similarly, the functioning of actual arbitration mechanisms for dispute settlement outside the debt arena (UNCITRAL arbitration rules, WTO panels and other experiences) could be analyzed.

There was also a call for a more systematic discussion of debt sustainability and its implementation. Perhaps there is no need for a separate paper dealing with the market view of the issue, but the market's perspective should be incorporated into the existing papers. The editors will look at the Portes and Cohen paper before deciding on this.

The papers are covering both historical and contemporary time periods, but all of them should focus on the lessons for today. It was felt that the country case studies should focus on the more recent period (1990s to today). Papers dealing with country experiences should also provide some analysis of the macroeconomic consequences of debt crisis and resolution.

One advantage of a meeting such as the present one is that authors could see the main concerns of the other papers in the prospective book. Authors should now be better able to avoid duplication. Cosío-Pascal and Schneider, both dealing with the Paris Club, albeit in different ways, agreed to be in touch with each other to this end and other authors were similarly to be encouraged in this direction.