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SOVEREIGN BANKRUPTCY: A PIECE OF THE INTERNATIONAL FINANCIAL ARCHITECTURE IS STILL MISSING

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"When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor."

Adam Smith (1776)[1]

Introduction

Sovereign governments have periodically run into problems servicing their debt for as long, probably, as they have had creditors. Sometimes the sovereign's debt crisis is a result of profligacy or bad management, but sometimes it is a consequence of unexpected economic developments that severely reduce normal revenues or require redirecting public expenditure to meet unanticipated needs (e.g., disaster relief). Sometimes the factor causing the interruption in debt servicing requires economic adjustment over several years, during which time debt-servicing capacity would remain impaired. Sometimes an inability to service debt as scheduled is temporary (e.g., cyclical) and will correct itself in time. Whatever is the source of the problem, if creditors do not have sufficient confidence to lend additional funds during the interregnum it triggers a crisis, usually imposing large costs on the borrower and often on the creditors as well.

This paper deals with international experiences in seeking to resolve the ensuing debt crises, particularly when the creditors are foreign. It discusses existing mechanisms, their failures, and directions for improvements. That the probability of default in lending to sovereigns is not zero — especially for developing and emerging economy governments — means that every unsecured loan to a sovereign embodies a certain risk of default and only partial recovery of funds. That risk has to be born and indeed is shared between creditors and debtors. For private loans, the market imposes a risk-related surcharge to the interest cost of the loan, which the debtor agrees to pay as a quid pro quo for receipt of the funds. For official loans, creditors typically impose conditions on the use of the funds or on policies to be followed by the receiving government aimed at least in part to improve the probability of repayment ("conditionality").[2] Finally, if defaults occur, the bankruptcy regime determines how the cost of default is divided between the debtor and creditors. A primary position of this paper is that the existing insolvency system for sovereigns, which has arisen as piecemeal and mostly ad hoc multilateral and legal responses to sovereign debt crises as they occurred over the past half century or so, does not do an adequate job. This mechanism has been able to address some issues fairly

[1] *Wealth of Nations*, Book V, Ch. III, Modern Library Edition, Random House, New York, 1937, p. 883 (cited in Hagan (2005), p. 300).

[2] Official creditors may also decide for political reasons to absorb the risk of default, as is implicit in concessional lending for official development assistance, as well as in unilateral debt cancellation or conversion of loans into grants, retroactive terms adjustment, and so on.

well, such as the collective action problem and creditor holdouts, which is to say it produces a “solution.” But a bankruptcy regime is written in national law, not only to reach a solution, but also to reach a solution that achieves desired economic and social outcomes, such as a ”fresh start” for a bankrupt entity that is not wound up. For sovereign bankruptcy, these latter goals have not been adequately addressed through the current system (or at least not without significant political pressure on particular cases).

The standard practice of the current system often involves developing and emerging economy governments to ask the International Monetary Fund (IMF) to indirectly coordinate the workout from debt distress. The Fund negotiates an adjustment program with the financial authorities of the debtor country to which is associated a package of multilateral (and sometimes bilateral) loans and a measure of debt relief to be requested from the different groups of creditors (banks, bondholders and suppliers, government creditors, multilateral institutions). Of course, staff of IMF cannot control the individual creditors, and neither can the major creditors within each group control the minor members (e.g., some bondholders may hold out from a debt swap in hope of collecting their full claims, and some bilateral creditors may not accept the debt arrangement agreed by the creditors in the “Paris Club”). Nevertheless, despite slippages on all sides and frequent delays and refiguring the adjustment program, countries usually emerge eventually from their crises, at least insofar as they can return to their normal sources of financing. Yet this is hardly sufficient.

An essential feature of our discussion is that our debtor is not just any entity but a sovereign government. Lending to members of this debtor class has traditionally been deemed the least risky of credits because governments’ taxation and foreign exchange management powers give them the ability in principle to cover their financial obligations. However, sometimes policymakers may become unable politically or administratively to mobilize that power or may be unwilling to do so or circumstances may have so hurt the population that any effort to raise additional revenue for debt servicing would be unconscionable. Lending to sovereigns entails believing that these occurrences are unlikely.

The need to discuss sovereign insolvency highlights another characteristic of sovereign lending, namely, that to speak of a bankrupt government is to use a metaphor. Sovereign debts are unlike any other. Creditors cannot force an insolvent government to be wound up or take possession of its remaining assets. And as we will have occasion to discuss below, although creditors can win a court judgment against a defaulting government, there is no reliable mechanism for collecting on that judgment.

Indeed, there is no internationally endorsed system of law or practice for how to address sovereign bankruptcy. There is rather a broadly common set of practices, albeit with many exceptions. Also, jurisdictions differ in the legal specifics of how to handle a sovereign’s default. Creditors of a defaulted sovereign can go “forum shopping” to find the most creditor-friendly jurisdiction in which to press their claims. However, they rarely collect on such judgments as they manage to win in court. Instead, actual debt restructuring has usually been achieved through informal negotiations and “voluntary” processes. In this regard, the treatment of sovereign debt crises is “political” at its core, in

the sense of relations among states or between a state and private (usually foreign) entities.

Sovereign insolvency is also political in another important sense; i.e., sovereign debt crises have become foci of internationally forceful political movements. Most prominent among these is the Jubilee 2000 campaign for debt cancellation for the poorest countries, whose broad popular mobilizations caused creditor governments and multilateral financial institutions to repeatedly break with their announced policies and agree to cancel, albeit grudgingly, increasing amounts of poor country debt in the 1990s and the present decade.[3] Sovereign debt problems in developing countries were perceived as pitting poor countries against rich creditors, inhibiting the ability of the poor people in those countries from raising themselves out of their poverty. Similarly, the debt crises in middle income countries, which have been mainly indebted to private creditors, were seen to have plunged millions of people back into poverty.[4] The basic charge was a political one: the approach lacks justice.[5]

One should want the debt workout regime to show ex post (after default) and promote ex ante (before default) efficiency and equity (see Stiglitz 2002, pp. 16-18). A workout regime with ex post efficiency would minimize the economic dislocation and pain in the economy of the defaulting government, promote economic growth and return the country to a sustainable debt situation. In other words, it would provide a "fresh start" with minimum human disruption. Ex-ante efficiency refers to how the bankruptcy regime affects behavior prior to bankruptcy. For example, if defaults are extremely unlikely borrowing rates would be very low. Creditors then might not exercise due diligence in differentiating good from bad borrowers, and borrowers that do not have the capability to repay might end up borrowing excessively. Ex-ante efficiency implies that this would not be the case.

One may in this way conceptualize debt regimes with more and less desirable characteristics and one should not be accused of dreaming in so doing. There is nothing immutable in the current approach to resolving sovereign debt crises. It arose in the environment created by the governors of the international financial system after the Second World War. Before the war, the internationally recommended means to resolve a sovereign insolvency that could not be addressed informally was inter-governmental arbitration, as formalized in the "Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts," adopted at The Hague in

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[3] One indication of the degree of popular mobilization is that just before the United Nations Millennium Summit, Jubilee 2000 presented to the UN Secretary-General a petition signed by 24 million people from 166 countries (Barrett, 2000, p. 17).

[4] A dramatic case in point is that of Argentina, where 45 percent of the population fell below the poverty line in 2002, the year after the debt default, roughly twice the percentage in 1990. Also, 19 percent of the population was classified as "indigent" in 2002, compared to 5 percent in 1990 (UN 2006).

[5] For a review of justice considerations in resolving sovereign debt crises from theological and philosophical perspectives, see Herman 2007, drawing on the New School and Carnegie Council "ethics and debt" project, a number of the papers from which will be available in April in a special issue of *Ethics and International Affairs* (vol. 21, No. 1).

1907.[6] Creditors at the time were primarily bondholders, as is increasingly the case today as well. Typically organized into creditor committees, the bondholders first sought to collect on the defaulted claims of sovereign borrowers themselves and when this failed sought assistance from their own governments. Representatives of the creditor governments would then negotiate with the debtor or plead the creditors' case in an arbitration proceeding.[7]

Apparently, on average, the debt crisis workouts under the pre-war regime had certain advantages over those of the post-war regime, albeit also certain disadvantages. In particular, the sovereign debtors seemed to receive greater degrees of relief from their private creditors, but it generally took longer to settle the creditors' claims, during which interest arrears typically accumulated as well, sometimes exceeding the original defaulted principal (Suter and Stamm, 1992). The point is not to express nostalgia for the pre-war years, but to remember that the current system is the product of our times. Previously, the governments of the powerful countries directly represented the interests of their resident creditors, while today many would say the powerful governments indirectly represent creditor interests through their influence in the multilateral institutions. Representatives of private creditor associations might strongly dispute that assertion, complaining that the international financial institutions are both political organizations that favor the debtors for foreign policy reasons of the powerful countries and creditors in their own right. Perhaps this means that none of the stakeholders are happy with the current system.

In the subsequent sections of this paper, we first describe in more detail what we find to be desirable characteristics of a sovereign bankruptcy regime. This serves as a normative benchmark for the remainder of the paper. We then suggest how the current system for relief of low-income country debt appears to have exhausted itself and merged into the aid architecture, how the sequences of restructurings of the debt owed by middle-income countries has placed a disproportionate share of the burden on the debtor's shoulders and not accorded them enough of the relief they needed, how the informal processes for negotiating relief of middle-income country debt appears to have lost its effectiveness in concerting the actors and pushing them toward effective and prompt debt workouts. Finally, we discuss possible directions in which to look for a more robust and fair international debt relief mechanism.

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[6] Part of a set of conventions on the laws of war, the text of the agreement, translated into English, may be found at http://www.yale.edu/lawweb/avalon/lawofwar/hague072.htm, on the website of the Avalon Project at Yale Law School. For an interpretation of the agreement by one of the negotiators, see Scott (1908).

[7] "Negotiate" could be put in quotation marks, as sometimes (but not often) the creditors' government intervened militarily on behalf of its citizens, perhaps the two most famous cases being the French intervention (supported by Spain and Great Britain) in Mexico in 1863, installing Austrian Archduke Ferdinand as emperor of Mexico (overthrown by the Mexicans and executed in 1867), and the joint German, British and Italian blockade of Venezuela's ports in 1902-3 (see Suter and Stamm, 1992, pp. 655-6). The aforementioned Hague Convention appears to have been an initiative of the United States, as it sought to update the Monroe Doctrine on preventing European military interventions in the Americas. Known as the Roosevelt Corollary, the US itself sometimes intervened instead, as in the Dominican Republic. Other cases led to European colonial expansion, as in Morocco and Tunisia.

Desirable Characteristics of a Sovereign Insolvency Regime

All restructuring agreements around the world, although under different frameworks, have the same objective: an early-negotiated deal based on a fair, predictable, participatory process. Although there are other effective bankruptcy regimes, U.S. bankruptcy law presents one such framework. Under U.S. law, debtors are treated differently depending on their juridical nature. For example, chapter 11 (for corporations) focuses on maximizing the value for creditors. In contrast, chapter 9 (for states and localities) focuses on limiting the pain for governments, given that it is not considered "fair" for creditors to take government assets or excessive amounts of future tax streams. Chapter 7 (for individuals) limits the discharge to financial assets, without involving the future financial stream. It is supposed to provide a "fresh start."[8] We believe a sovereign bankruptcy regime should focus on limiting pain and also aim to provide a fresh start.

Another dimension of a bankruptcy regime is the degree to which it is debtor or creditor friendly. When a sovereign bankruptcy regime is "creditor friendly," one could expect to see high penalties for default, low probabilities of default, and low interest rates. As mentioned above, one could expect that creditors would have lower incentive to carefully screen loan requests and monitor the borrowers, and debtors might borrow more due to the low interest rates and thus require greater reduction in claims after default.[9]

Under a creditor friendly regime, unilateral defaults are messy and penalties for default are high (or perceived to be high). When the cost of restructuring is high, countries have incentives to act strategically to increase official sector participation in the form of bailouts, as some claim happened in the 1990s. In the absence of such bailouts, countries might try to postpone calling default for as long as possible. Yet the very action of delay can be costly. To avoid default, sovereigns often rely on excessively stringent fiscal and monetary policies, sometimes with large long run costs. In Russia, for example, the delay in calling default led to such tight monetary policy that the economy ceased its normal functioning and many transactions were conducted in barter. In Argentina, the government took an extreme measure to avoid declaring default by using a debt swap to shift risk from the government's balance sheet to the banking sector's balance sheets in June 2001, severely weakening the local banking system. In both cases, the ultimate cost was ultimately much higher than if the countries had defaulted earlier.

In an effort to avoid the pain feared to be associated with unilateral default, many countries (especially smaller countries) have tried to quickly reach negotiated settlements

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[8] Based on Jeffery Sachs' comments at the Initiative for Policy Dialogue Sovereign Debt Task Force Meeting, May 2002. See www.policydialogue.org.

[9] By the same token, in more debtor friendly regimes, penalties of default would be lower and interest rates higher to compensate creditors for the greater risk of default. Under such regimes there would be more of an incentive for credit screening. With high interest rates and more credit differentiation, high-risk borrowers might find it more difficult to borrow. There is also a greater incentive for "strategic defaults" by the debtor, i.e. the sovereign chooses to default even though it has the resources to pay.

with their creditors before reaching the stage of unavoidable default. The ”market-based swaps” that became the main source of debt restructurings in the late 1990s and 2000s were one such measure. The primary goal of these swaps has generally been a quick and orderly work-out. The swaps have, in fact, been successful in achieving this goal. However, in the attempt to achieve a quick settlement and uninterrupted market access, the goal of debt sustainability has often been forgotten, as we discuss below. Market access are subject to bankruptcy regimes that have led to, or risk leading to, serial debt restructurings, without achieving debt sustainability or a ”clean slate.” Similarly, low income countries have also been subject to serial restructurings.

Experiences in Low-Income Countries

That a bankruptcy regime can have different possible goals is well reflected in how insolvency problems have been handled internationally for the governments of low-income countries. One may also see especially clearly the political essence of the workout from debt crises in the case of the low-income countries. Most of their medium-term foreign financing has been from official sources, primarily other governments, both directly and through multilateral institutions. What medium-term private foreign lending there is to the governments of such countries is mainly as export credits covered by guarantee of an official agency of the exporting country government. If the debtor defaults, the guarantee is invoked and the task of collecting on these loans passes to the export credit agency. In short, the debt workout in such cases is, *ipso facto*, an intergovernmental process.[10] The goals of this process have changed over time (which is not to say that the goals have not been necessarily all met).

The Initial Model: Temporary and Short-Term Relief

The formal mechanism for restructuring an insolvent country’s debts to official creditors was forged in the 1950s.[11] Under that mechanism, IMF suggests how much relief is required (sometimes in collaboration with the World Bank) and affirms that the debtor is cooperating to overcome its macroeconomic difficulties. Then the major bilateral official creditors meet at the French Treasury in the so-called “Paris Club” and in essence agree to the IMF’s proposal for debt rescheduling.[12] The Club functions as a coordinating mechanism for the creditors, aiming to prevent non-participating creditors from free-riding on the relief granted by other creditors. The principle is that all the

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[10] Admittedly, there are exceptions, as when low-income countries that have substantial supplies of exportable natural resources, such as petroleum, can access private financial markets.

[11] The Paris Club discussion is based in part on Cosío-Pascal (2006), which contains considerable additional valuable detail.

[12] Cuba’s treatment “outside the Paris Club” in 1982 provides an obvious exception, as it was not an active member of IMF at the time. Instead, a task force drawn from Paris Club creditors went to Cuba to discuss its economic adjustment program and financing needs (steering clear of United States concerns about compensation for nationalized properties). See Cosío-Pascal (2006, draft p. 11).

official creditors should sacrifice equally, or at least the bilateral ones, as multilateral obligations were left untouched by implicit mutual agreement, at least until recently. The Club members also devised standard terms of relief to apply to countries in different economic situations, revising them over time, but in general not following a "case by case" approach (albeit granting relief to individual country by individual country). The Club is, however, informal and the "Agreed Minute" setting out the broad terms of relief that is adopted at the end of a Club meeting on a country still has to be negotiated loan by loan by the debtor with each individual government creditor.

How wedded to this process are the creditor governments? They have only departed from it for politically important cases, of which there have been several. The first was Turkey in the 1960s, owing to its strategic importance as a member of the North Atlantic Treaty Organization. Second was Indonesia after the fall of Sukarno, when, after a series of standard Paris Club agreements (1966, 1967, and 1968), the donor governments supporting Indonesia invited Dr. Herman Abs, a renowned German banker, to recommend a settlement, which was adopted (with amendments) in 1970. His proposal embodied a grant element of 60 percent, amortization over 30 years and no interest payments for 15 years (Klein, 1973, p. 20). In addition, the agreement contained a "bisque" clause that allowed Indonesia to defer *at its option* up to half the principal due during the early years of the arrangement (Cosío-Pascal, 2006, p. 9). This was clearly a deeper degree of relief than the Club was extending to other countries and indeed Nkrumah's Ghana repudiated its almost simultaneous rescheduling agreement in part because it compared so poorly with that for Indonesia (Ghana did not settle until 1974).

Special treatment was also accorded later to Poland in 1990 and Egypt in 1991, two middle-income countries that ultimately saw their debt cut in half at a time when nothing like this degree of relief was being accorded to much lower income countries. The political importance to the creditor governments was clear in supporting Poland as the Iron Curtain crumbled and assisting Egypt following its support of the allies in the first Gulf war against Iraq. Iraq also received special treatment in the promise of an 80 percent reduction of its Paris Club debt in 2004. The Paris Club press release announcing that agreement on November 21, 2004 cited the "limited repayment capacity over the coming years" as the rationale for the permanent cut in Iraq's debt stock, something that in other circumstances might have been considered a non-sequitur.

Initially, the Paris Club did not see its function as returning the debtor to a sustainable debt situation, but rather buying time for adjustment policies to work (not to mention waiting for global economic recovery to take place, as debt servicing difficulties were sometimes associated with recession-related collapses in commodity export prices). The distinction commonly drawn today between liquidity and solvency problems was not considered in those early years. Consequently, debts were not reduced (except in the special cases noted above); rather, debt-servicing obligations were postponed. Commercial interest rates were usually charged on the delayed payments, in essence, making the rescheduling a form of concerted refinancing. Middle-income countries and the poorest of the poor received the same type of treatment.

The short-term focus was driven by the standard analyses prepared by IMF of the

debtor country's economic and financial adjustment needs. The Fund's mandate was to help member countries correct balance-of-payments problems, not development problems. The Fund in effect focused on the short-term net cash flow of the debtor vis-à-vis its foreign creditors, its so-called "net transfer of financial resources." This made the conceptual and policy link very strong between new credits and relief of debt servicing, especially as the creditors were virtually all official institutions. That is, a country could be supported with the same net transfer either through additional loans or additional relief.

Once a crisis began, virtually the only credits a debtor could receive would be bilateral official development assistance (ODA) and multilateral loans.[13] Medium–term guaranteed export credits would drop precipitously, first because the country would be taken "off cover" once it defaulted, and second, because it would likely be in recession and imports of investment goods would be severely cut back. However, while IMF extended undifferentiated balance-of-payments support, most other multilateral and bilateral assistance was designed for specific projects and programs. In this perspective, the option of providing a net transfer through debt relief became increasingly attractive as it became clear that servicing a growing debt would increasingly absorb the new flows, as budget resources are fungible, leaving less in the end for the programs the donors intended to support.

In other words, the rising level of low-income country debt became increasingly salient as it impinged on international financial cooperation policies for development. From the 1970s, this was reflected in a general easing of the terms of ODA, especially for low-income countries.[14] A number of aid givers even discontinued providing ODA as loans, making all their assistance as grants. However, these policies did not sufficiently relieve the already high and growing debt burdens of poor countries, especially as the multilateral institutions provided only loans, albeit on highly concessional terms for low-income countries. And when aid providers began cutting back their ODA flows to countries after the Cold War ended and confidence in the efficacy of ODA reached a nadir, it only worsened the pressure on the net transfer. Not surprisingly, a series of decisions increasing degrees of Paris Club debt relief accompanied the sag in ODA flows in the 1990s.

The Current Model for Low-Income Countries: the "Fresh Start"

Over time, the official creditor community (which is to say, the bilateral lenders and multilateral institutions) deepened its conception of debt relief. Today, official debt relief for the poorest countries includes virtually complete write offs of Paris Club debt

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[13] The debtor would also seek to maintain short-term bank credit lines to finance trade, on which it would be suicidal to default.

[14] A complementary policy, agreed in principle in discussions at the United Nations Conference on Trade and Development (UNCTAD), was retroactive adjustment of the terms of outstanding aid debt whenever a donor eased the terms of its new assistance (UNCTAD, Trade and Development Board, Ninth Special Session, Resolution 165 (S-IX), Section A, adopted March 11, 1978).

(which could be restated as Paris Club recognition that these debt were non-recoverable) and an almost complete reduction of obligations to the IMF, World Bank, African Development Bank, and Inter-American Development Bank was promised. The stated goal of relief has been to give the heavily indebted poor countries (HIPCs) a “fresh start” by placing them onto a sustainable debt trajectory.[15] In practice, debtor countries negotiate specific terms with their creditors, albeit within precisely defined relief guidelines stipulated first under the initial HIPC Initiative (1996) and then modified under the Enhanced HIPC initiative (1999).[16] Subsequently, substantial additional multilateral relief — initially claimed as 100 percent relief — was agreed as the Multilateral Debt Relief Initiative (MDRI) in 2006.[17]

While considerable reduction in debt servicing obligations has been promised — and some of it has already been delivered — in the HIPC and MDRI, the list of potentially eligible countries has been closed at 40.[18] All other countries are considered by the donor community not to require these degrees of debt relief. However, even assuming that the macroeconomic assessments of relief needs of the excluded countries are valid, the MDRI changed the argument for relief. Instead of aiming to eliminate the macroeconomic debt “overhang,” poor country debt relief now aims to remove budgetary and foreign exchange impediments to reaching internationally agreed development goals, in particular, the Millennium Development Goals (MDGs). If that is indeed the new principle for relief, non-HIPCs should potentially qualify. Indeed, when IMF extended its relief under the MDRI, it made the offer of relief consistent with an IMF policy called “uniform treatment” of countries. It thus made relief from repayment obligations to IMF

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[15] There has been some controversy over just how large a commitment was made to the HIPCs. Initially, in 1995 discussions, the goal was stated as reducing their debt “as part of a broader strategy to achieve long-run sustainability,” becoming in the first HIPC agreement in 1996 reducing debt to sustainable levels so as to provide a “durable exit strategy” from rescheduling cycles, moving in 1998 to providing a “robust exit” from rescheduling and “achievement of debt sustainability”, finally to a “permanent exit” from rescheduling and a “clear exit from unsustainable debt” in the Enhanced HIPC Initiative in 1999 (World Bank, 2003, p. 12). Subsequently, the goal seemed to be weakened: as stated by the Bank and IMF in 2003, the goal was to provide “a base from which to achieve debt sustainability and exit the rescheduling cycle” (as cited in World Bank, 2006, p. 13).

[16] For a case study of the increasing relief accorded over time to Ethiopia and the negotiations required to receive that relief, see Martin and Johnson (2007).

[17] As common in such exercises, the degree of net gain for the receiving countries was less than appeared at first sight. For example, the World Bank’s International Development Association (IDA), its concessional lending arm, is reducing its lending dollar-for-dollar to the countries receiving the debt relief (which is given as annual debt-service cancellation rather than reduction of the debt stock). Meanwhile, to compensate IDA for reductions in return cash flow from cancelled payments, donor governments have pledged equivalent new payments into IDA. These funds do not, however, replace the reduction in new loans of the relief-receiving countries, but are potentially disbursed to all IDA borrowers according to general lending criteria. For additional concerns on the MDRI, see Eurodad (2006).

[18] As of January 2007, 21 countries had reached the “completion point” at which “irrevocable” debt relief is agreed; 9 additional countries had reached the “decision point” at which interim relief is given and a list of policy “triggers” is agreed such that when they are met the country passes to its completion point; 10 other countries were deemed “potentially eligible” for the program although entering it would in several cases be contingent on the end of civil wars, unrest or “governance challenges” (For additional information from the World Bank, periodically updated, see www.worldbank.org/debt).

available to all countries meeting a particular income criterion (per capita income below US$ 380 per year), which added two non-HIPCs to its relief recipients.[19] Why this specific income criterion? Probably it is because the higher the per capita income cut off, the more countries are included, the larger the cost of delivering the relief, and the greater burden on the donor countries. Nothing else makes sense.

As part of the MDRI, developed countries agreed to absorb the participating multilateral institutions' cost of relief. The cost, then, ultimately is paid from those nations' foreign aid allocations. At the same time, the World Bank and African Development Bank are shifting increasing parts of their concessional lending to grant financing, which ultimately also requires increased donor aid expenditures if financing capacity of the institutions is to be maintained. In fact, many of the donor governments have pledged very substantial increases in ODA, so these obligations should be met. Indeed, the current major concern among the aid policy community is that aid-receiving countries should be able to effectively and efficiently absorb large increases in ODA. If these commitments are met, the net transfer of financial resources of many aid-receiving countries will be positive and large, and the concern is to manage the inflows appropriately so they do not distort the economy in terms of inflation and inappropriate exchange-rate appreciation. From a balance-of-payments perspective, this is the opposite of a debt crisis. For the poorest countries that are in this queue, the debt crisis is being fully absorbed into the aid architecture.

Not all poor countries, however, will receive these expanded aid commitments (although all are potentially eligible). Policy makers in the poor countries must still satisfy the donor community, as largely represented by IMF and the World Bank, that they will use the funds responsibly. Countries that are most successful in this regard may see the new flows arrive increasingly as budget support, leaving the receiving country to plan their use (it is not clear how many countries are even potentially in this category). Most poor countries will continue bound by the same international oversight of domestic policy that has characterized their adjustment programs over the past quarter century. In those programs, the "short leash," requiring annual or biennial debt relief agreements, along with IMF and other official new lending, was used as a disciplining mechanism. If countries slipped from the promised targets in their programs, funds would be cut and the next rescheduling agreement postponed. International oversight that developed countries would reject as excessively intrusive is standard fare for the poorest countries. But then, it's the donors' funds that are being transferred and the donors are governments or their multilateral institutions. These are political reflections of unequal power relations. Aid-dependent countries are told: follow donor policy prescriptions and receive (potentially) deep financial backing.

Further Reforms and Loose Ends

Is another model possible? Is a more comprehensive framework conceivable?

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[19] For additional details, see the periodically updated IMF "Factsheet" on MDRI on its website at http://www.imf.org/external/np/exr/facts/mdri.htm.

Yes, but it will take political mobilization to get there. Before collectively throwing up hands at that remark, one may underline the sea change in international debt policy regarding the poorest countries that was embodied first in the HIPC Initiative and then in the MDRI. It resulted from insistent political pressure from below on a number of the major creditor governments, pointing out their commitments to certain international goals and the reasonable expectation that they were not doing enough to reach those goals in most low-income aid-dependent countries. Some of the donor governments were vulnerable to this campaign and responded positively. None seemed to have a fundamental interest in opposing it. The policy was thus changed.

The most important aspect of the MDRI, as noted above, was the political re-conceptualization of debt relief: instead of relief sufficient to reach a “sustainable” debt burden (defined in macroeconomic terms), relief now should be such as not to impede attaining the MDGs, at least as far as HIPCs are concerned. This reflected what civil society activists have been calling the “human development approach” to debt sustainability, in which priority would switch from making contractually obligated payments, in particular for debt servicing, to morally obligated payments to meet essential social needs.

The question is can a further political change be envisaged that would speed additional aid resources to countries in which the donor community expresses less than complete confidence? One may answer yes, as tripartite processes have emerged from the HIPC Initiative on which to build the warranted confidence (Northover, 2007). However, it requires political space for citizen mobilization in the aid-receiving countries. Whereas there have been largely disappointing consultation exercises with civil society in preparing the Poverty Reduction Strategy Papers in low-income countries, there are a number of successful cases of civil society working with the government and donors in monitoring HIPC Initiative relief in order to ensure the freed up funds find their way to appropriate social programs and clients. The proposal is thus that the evolving development aid landscape be broadened, “transferring some of the more inclusive and transparent models of managing debt relief resources to the aid system” (ibid., p. 13). This would challenge the “cozy and secretive” relationship of donors and recipient governments when deals are made (ibid). It would require effective popular mobilization at country level and governments that appreciated the opportunity this presented for strengthening domestic governance systems.

The argument in this section, in sum, is that the treatment of the external debt problems of low-income countries has become deeply entwined in the international foreign aid architecture. As official creditors have been the overwhelming source of the debts of these countries that had to be restructured, there is heightened sensitivity on the need to monitor financial flows so that debt problems do not reappear, at least in the HIPCs and following the MDRI. Aid-receiving governments will be under an increasingly coordinated collective donor oversight, or at best tripartite cooperation to ensure effective use of aid funds.

There is, however, one loose end in this story: a number of middle-income developing countries, which are not bound by the precepts or agreements of the donor

community, are making increasing financial offers to low-income countries.[20] These other governments provide potential alternatives to the policy-package-*cum*-financing of the traditional donors. While some of the new financial offers are grants, many are loans and the traditional donor community already sounds exasperated that these "free riding" lenders may drive debt levels back to unsustainable levels.[21] Unmentioned is that these creditors may also abide policies outside the mainstream advocated by the traditional donor community. If this or some other scenario brings the poorest countries again into external debt crises, they will likely seek a different debt workout mechanism than the donor-directed one that they have operated under over the past decade and more. Right now, none such exists, although the last section of this paper suggests that work on developing such a mechanism ought to begin. The next section seeks to motivate that discussion for the case of market-access countries, arguing that the existing mechanisms do not deliver efficient, effective or just debt workouts.

Experiences in Market-Access Countries

Much of the debate on a sovereign bankruptcy for middle income countries has come to focus on the collective action problem, or how to bring creditors together to effectively agree to a restructuring proposal. This issue rose to the fore after the debt restructurings in the 1980s, and became even more important when the primary source of financing switched to bonds held by disperse creditors.

Bankruptcy law at the national level imposes a certain discipline on the creditors to restrain the "race to the courthouse" and later to prevent a minority from disrupting a debt restructuring ("cram down"), yet it also does much more, including: debtor-in-possession (DIP) financing, bankruptcy triggers, reorganization plans, and other issues. The existing system for handling sovereign bankruptcy spreads these functions across different institutions (e.g., IMF provides something of a counterpart to DIP financing) or does not provide them at all. As we discuss, the current system fails to successfully achieve the goals of an efficient bankruptcy regime.

From Syndicated Bank Loans to Bonds and Collective Action Clauses

The main processes for addressing the sovereign debt crises in the 1980s were the informal "clubs:" the Paris Club of official creditors discussed earlier and London clubs of commercial bankers that formed for each of the big sovereign debtors in crisis. The clubs served as places where public or private financiers could take debt-restructuring decisions privately and outside of courtrooms and government chambers.

The informal approach, especially as regards defaulted commercial bank debt,

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[20] The press features, especially, China and Venezuela, but there are other emerging creditors as well.

[21] For example, see the IMF/World Bank Development Committee Communiqué of September 18, 2006, para. 6 (available on the World Bank website at www.worldbank.org).

addressed the collective action problem among creditors and succeeded for a time in bringing the creditors together effectively for joint decision making. But creditors ultimately had different interests and by the end of the 1980s many had sold or swapped out of their exposure, while regulators and bank shareholders also pressed the remaining creditors to bring the situation to a close. The Brady Plan brought the era to a close, when the remaining bank loans were converted into marketable securities.[22] At the beginning of the 1980s, the syndicated structure of most of the large loans to developing economy governments created a ready-made structure within which to negotiate new repayment terms on those loans. At first, probably all bank creditors wanted to maintain the status of their loans as "performing" and thus agreed to refinancing of payments falling due, as long as they were "concerted" (i.e., all banks had to participate in proportion to their exposure). The thought was that the debtors had liquidity problems. Discipline among the creditors was good.[23]

However, as time wore on and the doubtful nature of the loans became increasingly apparent, bankers broke into essentially two groups. Those with long-run interests in the debtor countries were willing to continue to renegotiate their obligations, albeit with their shareholders and regulators expressing increasing doubt about whether the amounts due would ever be collected. The second group was comprised mainly of smaller banks (though it also included a few large banks) that had lent funds as a purely financial investment and wanted out of the process. A secondary market had arisen in the mid-1980s for trading these bank claims and some of them fell into speculative hands, which complicated negotiations for a final settlement. That is to say, if one bought, for example, Mexican obligations at 50 percent of face value, then any final settlement above that level was profitable to the new owner of the loan, while representing a loss for original lenders that still held their claims. There was no stopping it: this plus increasing regulatory and shareholder impatience made deeper discounts than before more acceptable to the creditor side as a whole. This issue would become even more complicated in the 1990s, when derivative markets would allow creditors to actually hold a net short position on a country's debt.

Policymakers were left to worry whether they could replicate earlier commercial bank discipline in sovereign debt restructurings in the 1990s, as bonds became the main debt instrument. One of the most widely discussed creditor coordination problems was the threat of holdouts: minority bondholders who threatened to block an agreement acceptable to the majority -- unless they, the minority, were offered better terms for themselves. To address the problem of holdouts, as well as other problems associated with sovereign restructurings, the IMF proposed the Sovereign Debt Restructuring Mechanism (SDRM) in 2001. Senior officials of the US Treasury and market players vehemently opposed this approach, and pushed for including collective action clauses (CACs) in bond contracts as an alternative to the SDRM, so as to encourage collective creditor behavior, the so-called "contractual" approach. This was deemed less intrusive

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[22] This discussion is based in part on that by a debt negotiator for Colombia in the 1980s prepared for the IPD Task Force (see Garay, 2006)

[23] There were also legal impulses to cooperate, in that "sharing," "pari passu" and "negative pledge" clauses in loan covenants discouraged lenders from seeking individual redress in the courts.

than a “statutory” approach and less likely to disturb the “voluntary” and informal nature of restructuring the obligations to private creditors.[24] Today, most countries include CACs in their new bond issues. However, CACs cannot address conflicts between different classes of creditors (such as bondholders, banks, multilateral lenders, and bilateral lenders).

The main function of CACs is to specify how to reach a decision to restructure a bond. The CAC process is conceptually similar to the one followed in the 1990s and early years of the present decade, except that it pre-specifies the “supermajority” required for adoption of the new terms.[25] In actual application, one might expect the defaulting sovereign to sound out major groups of bondholders, as with pre-CAC bonds, and then to unilaterally offer a new deal on which the bondholders would vote. With pre-CAC bonds, bondholders “voted” by offering their old non-performing bonds in a swap for a new bond that would either have a more favorable repayment profile or a reduction in the face value or interest rate. To discourage holdouts, participants in the swap sometimes voted on “exit consents,” which changed the terms of the old bonds so as to reduce their legal standing.

It is not clear if CACs will prove important to the successful completion of future bond swaps or other restructurings. [26] Bonds issued under British law have traditionally incorporated them. In addition, the “exit consent” mechanism used in the Ecuador and Uruguay debt restructurings seemed to provide an alternative approach to the use of CACs. Moreover, Argentina’s debt restructuring relied on neither CACs nor exit consents (although the new bonds include CACs). It attracted 76 percent of bondholders and was declared valid. Holdouts have protested loudly, have gone to court in various jurisdictions and have recently even had a case accepted at the international arbitration panel operated by the World Bank (the International Center for the Settlement of Investment Disputes). Not one holdout, however, has yet to see a dime, although favorable court decisions have been made in certain jurisdictions. In short, the “contractual approach” bumps up against the unenforceability of contracts with a sovereign. CACs are simply a way to help organize the vote on a “voluntary” exchange of new bonds for old ones.

It also appears that the effort to bring a form of "relationship banking" to a world of bond finance is having only limited effect. That is, following the Mexican crisis of 1994, there was both an effort to encourage governments of emerging market countries to provide more and more up-to-date data to the international investing public, and an effort to improve the discussions between borrowing governments and their private creditors. The former became the IMF's Special Data Dissemination Standard, to which most emerging market countries have subscribed, and the latter has been turned into the

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[24] The reason that unanimity provisions were originally incorporated into securities issued under New York law was to protect the rights of minority shareholders and ensure that a majority (or a super majority) did not use their voting power to deprive a minority of their “rights.” The new CACs in New York law bonds reversed that position.

[25] It would also reduce the legal standing of bondholders that did not agree to participate in the restructuring.

[26] For a rather skeptical view, see Gelpern and Gulati, (2007).

"investor relations programs", government committees that engage with creditor groups via conference calls and other means. An additional initiative was to develop a "code of conduct" for how creditors and debtor governments should interact. The latter became the "Principles for Stable Capital Flows and Fair Debt Restructuring" (IIF 2005), which has been endorsed in the private sector and welcomed by a number of governments, as reported by the Institute of International Finance (IIF 2006). However, there does not seem to be a practical embrace of the consultative processes that underlay the idea of the code. In short, bondholders are not like old-fashioned bankers who develop ongoing and personal relations with clients over time. The nature of the current financial relationship is rather more arms' length.

It is also unclear what the future of restructuring exercises through bond swaps – or indeed, new bond international bond issuance – will be after Argentina. A large number of Argentine bondholders did not accept the swap, and their efforts to collect funds through court actions all but preclude Argentina from returning to international financial markets. This has not hurt Argentina as yet, as international bond buyers have been attracted to Argentine bonds issued under local laws. Also, Argentina has not needed much borrowing. Finally, the announcement by Ecuador that it might not make its February interest payment and seek restructuring was a blow to market confidence, as the country is not in a current debt crisis but rather feels it is imperative to change the terms of its borrowing to less disadvantageous ones. How confident should creditors be, in other words, that Ecuador or other debtors might not seek to reopen bond agreements that governments find were inappropriate, let alone "odious"?

Market Based Swaps as a Mechanism for Restructuring

Most of the recent market based swaps have been successful in solving the creditor coordination problem – they have generally represented quick and somewhat orderly restructurings. However, as stated earlier, market based swaps have not been as successful at reducing debt levels. They do not give countries a clean slate. Indeed, the aim of many of the swaps has been to accord enough breathing space to the debtors to ease a constraint on economic recovery in order to return the debtor to full debt servicing and full market access, rather than reduce debt levels. Table 1 shows information on five restructurings through that occurred between 1997 and 2005. The first notable point is that the swaps extended maturities and offered new bonds at lower interest rates than the market would have priced on its own, but only one country, Ecuador, experienced any write-down in principal.

Table 1: Sovereign debt distressed exchanges 1997-2005

Source: Bloomberg, or as indicated.

Country	Year	Type of event	Description	Exchange terms	Moody's recovery proxy

Dominican Republic	2004-05	Exchange accepted: extended maturities but no write-down of principal. Note: events preceded by severe banking crisis in 2003.	Late payment on Brady Bonds, followed by selective default on commercial debt (single loan), followed by missed payment and exchange offer.	Extended maturities on Eurobonds and announces intention to add exit clause to the eligible bonds.	93.625; 92.00
Uruguay	2003	Distressed exchange on international bonds.	Negotiations to reschedule debt to multilaterals, followed shortly by exchange offer on external bonds.	Extended maturities, some cash incentives, coupons between 7 and 8%, exit amendments added to old bonds.	61.18, 65.64
Ecuador	1999	Missed payment followed by official default and request for debt restructuring.	Brady bond default followed by Eurobond default.	Extended maturities and principle write-down. Recovery value in market estimated at 70% based on NPV.	59.88, 30.01
Pakistan	1999	Distressed exchange prompted by Paris Club comparability demands.	Distressed exchange offer on Int'l bonds (Nov 99).	Maturity extended, 10% cpn, principal payments from end of 3rd year.	40.00, 55.00
Ukraine	1997-, 2000	Distressed exchanges	Distressed exchange on Eurobonds in July 97. Next Eurobond issue in 2002.	Extend maturity, new cpn of 11%	69.25, 68.60

The result is that debt burdens of most countries remained remarkably high post restructuring. Even in Ecuador, external debt remained at 65% of GDP after the debt swap. Just two years later analyst reports were quoted as saying that Ecuador would be able to continue to service its bonds… as long is it ran up ***arrears*** with bilateral institutions and suppliers.[27] In other words, according to these analysts, Ecuador would only be able to repay its newly restructured bonds if it defaulted on debt to other creditors. Uruguay was left with debt at 99% of GDP and debt servicing at 46% of exports following its restructuring. As in Ecuador, just one year after the swap, analysts were discussing Uruguay's continued debt problems.[28]

Because of the low level of debt reduction, creditors have recovered very high percentages of their initial loans to emerging markets in most cases that countries have restructured their debt, especially compared to corporate bonds, as we show below. The high recovery values are reflected in high returns on the sovereign bonds. The emerging market bond asset class has been the best performing of all fixed income asset classes, yielding the highest returns, even on a risk adjusted basis (Spiegel 2005). Creditors are getting paid for the risk of default by high interest rates, but defaults are not that common, and when they do occur, the recovery value that investors receive is much higher than what's being priced into the market.

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[27] Salomon Smith Barney, Economic and Market Analysis, Country Analysis and Commentary, May 13 2002.

[28] Citibank and IPD breakfast meeting on local markets, 2004.

Because there is no clear definition of bankruptcies for sovereigns, the recovery value is a matter of negotiation. The implication is that, when default does occur, there is large uncertainty regarding the recovery values. There is a large literature on corporate defaults and corporate recovery values (Altman, 2003), but very little history or research on sovereign recovery values. Rating agencies, such as Moody's, estimate recovery values using market prices one month following default. Table 1 gives recovery values for emerging market debt calculated by the rating agency, Moody's Investor Service. For example, the recovery value on Uruguayan debt is 61%, which is less than would be expected for a restructuring with no principle reduction and coupons still approximately 5% [ck] above Treasuries. This measure assumes that markets are efficient and that the price following default represents a true expectation of future payments. But, emerging markets are subject to information imperfections and enormous uncertainties (partially based on the uncertainty regarding restructurings and recovery values.) Spiegel (2005) derives a new measure to estimate recovery values. Based on investor holding periods, she find that the one month default prices grossly underestimate recovery values for sovereign bonds: when bondholders don't liquidate their holdings following a credit event they receive a substantial premium over the default price. In fact, on average, investors who held their bonds for a year and a half after the credit event actually had a positive rate of return, with annual returns averaging 4% for a 3 year holding period and 1% for a one year holding period. Investors are getting paid for the risk of default in the form of higher interest payments paid by developing countries, but the actual loss from defaults across the asset class is significantly less than what is priced into the market.

The implication is that a better bankruptcy framework would not impede market efficiency. The market already has inefficiencies due to the huge informational uncertainties. To the contrary, a better framework for debt workouts would not only help countries achieve a "clean slate," it could also improve market efficiency. Yet, if the existing system for workouts from sovereign debt crises thus seems unsatisfactory in terms of the outcomes it produces, we still have only half an argument for seeking to change it. We need to have proposals that promise a superior outcome that are also institutionally feasible under the current world economic and financial system.[29]

Conclusion: More Powerful Instruments are Needed

Without a global empire or a global government, decisions of a sovereign bankruptcy court could only be enforced on sub-sovereign actors, such as the private creditors. Participation of the sovereign debtor would have to be voluntary. "Sovereign bankruptcy" has to be understood metaphorically. Indeed, most of the practices in resolving sovereign debt problems involving private creditors since the 1980s have been informal. However, the processes of this sort that are available today seem less and less adequate.

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[29] That they should be politically feasible is something else and is dependent on effective mobilization of support for the proposals.

The argument in this paper began by indicating how the debt problems of low-income countries have largely been subsumed in their aid relationship with their major donors, from which aid donors would do well to look at experiences in monitoring HIPC relief for lessons that might be applied to the aid relationship more generally. We also noted, however, that other, new creditors are lending funds to these countries and that the donor-dominated debt-workout process may not be attractive to sovereign debtors or some of the creditors in a next round of debt crises. Right now, there is no other option, whether the creditors to these countries are private or foreign governments.

If the above paragraph hints that there is a missing piece in the international financial architecture, the argument in the rest of the paper seeks to make that claim definitively. It is clear now that it is in the nature of the private foreign financial claims against a sovereign that courts cannot enforce them and that lenders necessarily bear a measure of risk in lending to governments. Credit default swaps are an easily understood response. It is also argued that informal processes that maintained creditor discipline in the era of bank lending had run their course by the end of the 1980s and would become even less effective in the era of bond finance. Finally, a voluntary code of conduct was no solution, as it could discipline neither the debtor nor the creditors. This does not imply that every sovereign debt crises will end in chaos. Somehow they are eventually resolved in every case. For the resolution to be timely, effective, and fair, however, some stronger initiative is needed than we have yet seen, one that uses the state and law in a different way.

In fact, powerful states have usually been central to workouts from major financial crisis. While concerted meetings of bankers may have saved Korea from default at the end of 1997 and rescued the US financial markets from the challenge of Long Term Capital Management in 1998, it is important to recall that the concerting was done by the Federal Reserve Bank of New York and the US Treasury. Perhaps the last time the private sector rescued a country from financial crisis was when J.P. Morgan coaxed some of his banker friends at his apartment on the 31st floor of 14 Wall Street to work with him to finance the workout from the U.S. financial panic of 1907. That experience, however, prompted the US authorities to create the Federal Reserve System. At global level, a strong, well-financed and more representative IMF, inspiring high confidence in debtor as well as creditor countries, seems to be the essential starting point.

The IMF, however, is not also the end point. The Fund's experience in proposing to create the Sovereign Debt Restructuring Mechanism (SDRM) in 2001-2003 is an important experience to learn from. SDRM was rejected for shortcomings in itself (for example, being perceived as an arm of IMF, and not an independent forum), and as a representative of all "statutory" approaches, which the private creditor market feared would reduce the recovery value of their non-performing loans in a default situation (most likely an exaggerated fear, post Argentina).

It also seems that the SDRM failed because it was rushed from vague idea to concrete legal proposal before enough of a constituency developed in support of it.[30] It

[30] The story of the rise and fall of SDRM is well-told in Setser (2006).

was perhaps perceived as a temporary opportunity; but that in itself should have been cause for concern, as it meant the proposal could (and did) develop powerful enemies. Indeed, the proposal to adopt the SDRM through an amendment to the IMF Articles of Agreement was perceived as a way to force it on developing countries, which account for a disproportionately small share of IMF votes. With the benefit of hindsight, a more open strategy, fostering discussion and building momentum behind an idea first, drafting details second, and winning consensus support third seems the only way to proceed.

This notwithstanding, the SDRM had certain positive features that should not be lost. It embodied mechanisms for the creditors to coordinate their positions within and across different classes of lenders (albeit compromised in later iterations of the proposal by not insisting that Paris Club creditors be part of the process). A well-designed process could protect the rights of minority, as well as majority, creditors. It could give debtors the opportunity to call default through a structured process, and provide a forum for debtors to talk with their creditors – with the goal of negotiating debt restructurings that give countries room to grow.

The SDRM was also, importantly, a political process, one to be adopted, in effect, by treaty, ratified by parliaments and under which all governments would have felt obligated to try to bring debt difficulties to a reasonable resolution. In fact, the actual SDRM proposal fudged the issue of the goals that settlement of a sovereign debt crisis should aim to achieve. It was content to let the various parties work out a solution (albeit with the debtor government under an IMF adjustment program and thus operating on assumptions about a net transfer of financial resources that the creditors would have been expected to realize).

However, once creating a new international institution, there is every reason for the international community to take an interest in the quality of the solution it provides, the degree of relief, whether the country emerging from its debt crisis simply is able to resume normal borrowing or is put on a sustainable debt path, let alone whether the debt workout deprives the government of essential resources to meet internationally agreed social obligations. As was seen in the special treatments in the Paris Club in politically important cases, governments do not shy away from acting collectively on political grounds through institutions like the Paris Club when deemed necessary. There are internationally agreed principles and priorities with important development and social dimensions that governments should not hesitate to apply fairly across the board. These are shared political goals as much as financial stability and international comity.

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