Dealing Justly with Debt

This past year has seen the economic collapse of Argentina, crises in Brazil and Turkey, and the continued suffering of poor countries, all partly as a result of high indebtedness. Sovereign debt can contribute to problems of many kinds. It can limit countries' capabilities to provide the basic social services that are required to secure minimally decent living conditions for their citizens, and can make it difficult for countries to pursue policies that are likely to contribute to their long-term development. In addition, ineffective and unfair mechanisms for managing the restructuring of debt can lead to defaults that may also significantly harm creditors' and investors' interests, and can create disincentives for lending and investment that can be crucial to the prospects of wealthy and poor countries alike. An often overlooked but very important effect of financial crises and the debts they often engender is that they can lead to increased dependence of developing countries on foreign creditors and international institutions, limiting the capabilities of their citizens to exercise meaningful control over their policies and institutions.

There has been growing public recognition of these problems, and increasingly potent popular movements have pressured governments, financial institutions, and the financial community to explore creative new ways of addressing severe indebtedness. Some of these, including the Highly Indebted Poor Countries initiative, have focused on securing debt relief for very poor countries. Others, such as proposals for institutional arrangements that would identify odious debts, have sought means of distinguishing debts to which creditors have a valid claim from debts to which they have no entitlement. However, the increasing incidence of middle-income countries experiencing debt crises suggests that the problem of sovereign debt needs to be evaluated beyond these two categories, taking into account the structure of the international financial system and the roles of its various participants.

The contributors to this roundtable investigate the broader question of how to structure sovereign debt negotiations in a way that will help to prevent countries from falling into financial crises and indebtedness, and to enable those that do to escape more easily without imposing unacceptable costs on other parties. The contributors differ sharply in their diagnoses of the causes of severe debt, the agents who are primarily responsible for bringing it about, and the extent to which remedying this problem will require deep reforms to the global financial system. But each advances concrete and feasible proposals concerning the design of institutional arrangements that, they argue, can improve the fairness of processes for dealing with sovereign debt even in the short term.

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Resolving International Debt Crises Fairly

Ann Pettifor

If global economic justice is to be achieved, debt crises must be assessed within the broader context of the international financial system. This system, which has been largely imposed by a small group of powerful financial agents in the Organisation for Economic Co-operation and Development countries, has led to instability and recurrent financial crises that have severely harmed the interests of poor countries and their people. Responsibility for bearing the costs of debt crises and other negative effects of the prevailing international financial system should therefore be assumed by those who have contributed to bringing them about. At present, however, the burden of economic "adjustments" during debt crises has fallen disproportionately on poor debtor nations, and debates regarding debt management have been dominated by individual, corporate, and official creditors. This essay presents the case for institutional reforms that can better protect the human rights of citizens of sovereign debtor nations during debt crises.

RESPONSIBILITY, IMPARTIALITY, AND ACCOUNTABILITY

Several principles should guide the design of institutional arrangements that can deal justly with debt. The first is that there should be recognition that it takes two parties to make a loan, and that each of these two parties can be reckless, irresponsible, and delinquent in its actions. Insofar as either party to a loan acts in this way, it ought to shoulder part of the burden of the crises that often ensue. Losses from bad loans and bad debts should not, therefore, fall solely on the debtor. The second principle, based on a fundamental principle of the rule of law, is that no one ought to be judge in their own court. Any courts that are developed to resolve debt crises must be fair and impartial with respect to the parties to the loans in question. The third principle is the principle of accountability. Sovereign debt crises are public, not private, crises involving the use of taxpayer funds. If the resolution of these crises is to be achieved within a framework of justice, and if democratic scrutiny of public funds is to be strengthened, then it will be vital for the process to be open, transparent, and accountable to citizens and taxpayers.

Unlike proposals recently put forth by the International Monetary Fund (IMF) and by private creditors, the Jubilee Framework for resolving sovereign

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debt crises expresses these three principles. The framework is based on the proposal originally developed by the Austrian economist Kunibert Raffer and is modeled on Chapter 9 of the U.S. legal code, which regulates the bankruptcy of municipal and governmental organizations.[1] The particular attraction of the Chapter 9 model is its applicability to governmental institutions and its protection of taxpayer and employee interests in the resolution of municipal and other governmental debt crises.

The Jubilee Framework envisions an independent court that would be representative of all creditors and the debtor nation, and would treat their interests on equal par. The framework rejects a role for the IMF that would discriminate against other creditors by protecting its own claims, and is highly critical of a process in which the Fund would have strong agenda-setting powers. However, it recognizes that the IMF will play an important financing role by providing working capital in loans to the debtor country while negotiations proceed, and that the repayment of these loans will take priority over other loans. It also suggests that the UN should oversee debt sustainability analyses but, in the absence of available resources, recognizes that the UN could only play a marginal role in the process. In this respect, the Jubilee Framework differs from the proposals of other civil society organizations, such as Erlassjahr in Germany[2] and the African Forum & Network on Debt & Development,[3] which reject a role for the IMF and instead see the UN as the main arbiter in negotiations. However, such differences are not fundamental, as most civil society organizations agree on the need for an independent, fair, and transparent process of arbitration.

INTERNATIONAL ECONOMIC JUSTICE

The first objective of any sovereign debt crisis resolution process should be the achievement of international economic justice with respect to the designers of the international financial system—the G-7, its members' representatives in the Bretton Woods institutions, the Bank for International Settlements, and the central bankers of the economically powerful countries—and its victims—the people in the indebted countries. The Bank for International Settlements has acknowledged

[1] Kunibert Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face," *World Development* 18, no. 2 (1990), pp. 301–13. See also Professor Raffer's Web site, mailbox.univie.ac.at/~rafferk5/art.html.
[2] Erlassjahr, "A Fair and Transparent Arbitration Process for Indebted Southern Countries"; available at www.erlassjahr.de/15_publikationen/15_dokumente/englisch/ftap_englisch_rz.pdf.
[3] AFRODAD, "AFRODAD's Call for a Fair and Transparent Arbitration Court for Debt"; available at www.afrodad.org/HTML/Examination%20of%20FTA.htm.

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that the liberalization of financial systems, led and promoted by the central bankers and finance ministers of the G-7 countries, has

> Over the past few decades . . . arguably also increased the scope for pronounced financial cycles. In turn, these cycles can contribute to the amplification of cycles in the macroeconomy, and in the past have all too often ended in costly banking system crises. While both industrialised and emerging market economies have been affected, the damage caused by financial instability has been particularly serious for emerging market countries.
>
> At the root of these cycles typically lies a wave of optimism . . . [which] contributes to the underestimation of risk, overextension of credit . . . . Eventually, . . . the imbalances built up in the boom need to be unwound, sometimes causing significant disruption to both the financial system and the real economy.[4]

Such admission of fault and responsibility should provide a backdrop to any consideration of how losses arising from the "significant disruption to the financial system" should be shared between industrialized and emerging market countries. Current international practice places the burden of major economic adjustments for losses on the debtor. What is often not taken into account, however, is that the real burden for such adjustments falls not on the actual borrowers—who are often corrupt presidents, finance ministers, and central bankers of debtor governments—but on the taxpayers of current and future generations, including poor people who experience the costs quite acutely. In the absence of a resolution of the Argentine debt crisis, for example, since the default of 2001, the population living below the poverty line has risen to 50 percent. Of these poor people, 33 percent are indigent, forming the most underprivileged sector of Argentine society. Moreover, a system that allocates the costs of repayment of debt to those that did not incur them engenders further misestimating of risk, leading to further bad borrowing and bad lending.

Neither the IMF's proposal for a sovereign debt restructuring mechanism nor the private-sector alternative reflects any recognition of the role that creditors have played as designers and primary beneficiaries of a financial system that precipitates crises by encouraging reckless lending and borrowing. Both multilateral and private lenders represent the process of dealing with debt as an act of mercy, rather than as a process for restoring stability and economic efficiency on the one hand, and, on the other, as a struggle to mitigate injustices in the current global financial order. As a result, their proposals serve to maintain the status quo.

The IMF's Sovereign Debt Restructuring Mechanism (SDRM), for example, is not equipped to deal justly with debt because its design does not assure a balanced

[4] Bank for International Settlements, "71st Annual Report: 1 April 2000–31 March 2001," p. 123; available at www.bis.org/publ/ar2001e.pdf.

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process in which each interested side is represented on an equal par. [5] It violates the principle of the rule of law—allowing a major creditor to be judge in its own cause. The mechanism would be overseen by the Fund's own executive board, which is dominated by the official creditors of the powerful G-7. The Fund's proposal would ensure that Fund staff and the executive board would play a preemptive role in shaping the outcome of the debt crisis resolution negotiations by setting the country's level of debt sustainability, on the basis of which will be determined the necessary debt reduction. In addition, the Fund will continue to play a substantial role in shaping the debtor's economic policies, by providing technical assistance and advising on fiscal, monetary, and legal policies during the period over which the country is being granted relief. As a result, the IMF will effectively draft the composition plan for restructuring debts and financing their repayment that should rightly be presented, as in domestic bankruptcy law, by the debtor in order to provide the basis for fair and effective negotiations.

By determining the composition plan, the IMF disempowers the debtor, all other creditors, and civil society. The IMF could, and very likely will, set the debt sustainability to a level that does not place its own claims economically at risk, even if they were legally exempt from debt cancellation, in case the debtor transferred all its available resources to the repayment of private-sector debts.[6] Indeed, it was even suggested at an IMF conference that took place in Washington, D.C., on January 22, 2003, that if debtors were to agree to solutions that were considered "too generous" by the staff of the Fund, the IMF would penalize the debtor—for example, by withholding funds—thus blocking the solution agreed to by both parties. Above all, this would allow the Fund to play the role of a judge in its own cause—the defense of its own claims. While the Fund might argue that its preferred creditor status enables it to provide crisis financing, much of the outstanding IMF debts do not represent crisis financing but development financing. This is because the IMF has long overstretched its fire-fighting role in international finance and has increasingly engaged in micromanaging economies. The case of Argentina is a striking example of this—the country's debts have been accrued as a result of sustained lending and failed structural adjustment programs over the course of more than fifty years.

By enshrining the SDRM in its articles of agreement, the Fund would go further. First, it would change the present situation where the IMF and the World Bank together engage in poor country debt management. Second, if the IMF were to enshrine

[5] International Monetary Fund, "The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations," November 2002; available at www.imf.org/external/np/pdr/sdrm/2002/112702.pdf.
[6] Ibid., paras. 84, 85, p. 25.

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the executive board's authority to define the behavior of the debtor as a breach of its obligations under the articles of agreement and to determine sanctions against the member country, it would put debtor countries in a situation of coerced choice—since the costs of exiting the Fund are very large. Third, the amendment to the articles of agreement would legally entrench the IMF's present status of preferred creditor.

The approach preferred by private creditors, that of collective action clauses (CACs), would pit powerful creditors against a weakened debtor in behind-the-scenes negotiations. There may be circumstances in which the debtor is powerful enough to engage forcefully with creditors. Past experience of poor country debtors, however, shows that they lack the resources to hire the legal staff necessary to ensure equality and justice in the negotiations. The imbalance in the relationship between creditor and debtor can only be corrected by a proper legal framework in which both are protected. It is the statutory framework (in this case Chapter 11 of the U.S. legal code) that provides incentives for private creditors to negotiate with the management of defaulting companies like Enron. It is the lack of a comparable framework that leaves them unwilling to do so with Argentina.

A further objective for any framework of debt negotiation should be to reduce and punish the incidence of corruption, fraud, and criminality associated with international lending and borrowing. The only way in which this can be achieved, and indeed is achieved in Western economies like that of the United States, is through mechanisms that ensure public scrutiny of public officials. It is the existence of regulatory authorities, transparent reporting, and the threat of punishment that discourages corruption in financial centers like London, New York, and Zurich.

We have been pleased to note that the IMF's latest draft of its SDRM proposal calls for much greater transparency in the sovereign debt restructuring process.[7] Unfortunately, one major weakness in the IMF's Sovereign Debt Dispute Resolution Forum remains.[8] Although the IMF has consulted the UN Commission on International Trade Law to ensure its independence, the IMF nevertheless denies the Sovereign Debt Dispute Resolution Forum powers to challenge the decisions of the Fund, such as its assessments of the amount of debt reduction that will be needed to resolve a particular debt crisis.

EFFICIENCY, STABILITY, DEVELOPMENT

The second objective of any insolvency framework should be economic efficiency, stability, and development. The main rationale for bankruptcy law is that

[7] Ibid., paras. 14, 273, and 291, pp. 6–8, 70, and 74.
[8] Ibid., paras. 28, 230–63, pp. 11–12, 57–67.

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releasing bankrupt economic agents from debt bondage will encourage them to contribute productively to the economy once again.

There is ample evidence to suggest that the economic policies effectively imposed by foreign creditors over the past thirty years, particularly through the IMF, have failed to return countries to sustainability, or to encourage economic growth.[9] Using their influence in the IMF, the G-7 countries have effectively been imposing economic policies on indebted countries in Latin America and Africa since 1982, and over that period economic growth in those continents has been lower than during the period between 1945 and 1980, with a consistent decline in GDP in some cases. [10] On the whole, and perhaps logically from the point of view of the creditors who dominate the executive board, IMF policies have been designed to extract and transfer assets from debtors to creditors. One of the most likely and predictable outcomes of the SDRM is that countries would not be returned to sustainability. Just as under the failed Brady Plan of the 1980s, under the SDRM only private creditors would have to reduce their claims. As the IMF's proposal stands, public creditors like the Fund, the World Bank, and all the regional development banks would have their debts excluded from debt restructuring negotiations. There have been some suggestions in informal talks during meetings and conferences that the Paris Club of sovereign creditors would be included within the SDRM but an official intention to do so has not been confirmed. This would be ineffective and unjust because it fails to ensure that the debtor's crisis is addressed comprehensively and limits the accountability of official creditors like the IMF and World Bank. Indeed, even relatively generous debt reductions by the private sector might be insufficient to return debtor nations to sustainability. With respect to unsecured creditors, the IMF's proposal asserts that they would receive a combination of "cash and new securities."[11] If this cash is provided in the form of an IMF loan—because the overindebted country has no hard currency—the principal debt will increase. Furthermore, the debt will rise, because the IMF gives out harder loans, that is, loans that normally have to be repaid over a relatively short period at interest rates that may not be concessional.

Any framework for debt restructuring will involve the assessment of the assets of the sovereign. The institution that provides these assessments must include transparent and inclusive procedures that involve the citizens of the

[9] For evidence of the impact of these policies on economic growth in emerging markets, see Ann Pettifor, ed., *Real World Economic Outlook,* vol. 1 (London: Palgrave, forthcoming, September 2003).

[10] See Mark Weisbrot, Robert Naiman, and Joyce Kim, "The Emperor Has No Growth: Declining Economic Growth Rates in the Era of Globalization" (Center for Economic and Policy Research Briefing Paper, May 2001); available at www.cepr.net/globalization/The_Emperor_Has_No_Growth.htm.

[11] International Monetary Fund, "The Design of the Sovereign Debt Restructuring Mechanism," n. 17, pp. 35–36.

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debtor nation. It will also be necessary to develop reasonably precise principles for determining levels of debt sustainability that are consistent with the protection of human rights. We believe that UN agencies such as the United Nations Development Programme and UNICEF are best placed to advise the court on the resources that will be required to ensure that the human rights of the people of the debtor nation are well protected. Indeed, much of the work currently being undertaken by the UN to measure the costs of achieving the Millennium Development Goals could contribute to assessments of a debtor's sustainability.

The Jubilee Framework calls for an ad hoc, independent debt crisis resolution body, with transparent procedures, representing the interests of both the creditors and the citizens of the debtor country, with an independent judge ruling on the final composition plan. This body can be modeled on the arbitration panels used by the International Chamber of Commerce for the resolution of disputes between corporates and sovereigns. Specifically, all civil society frameworks call for a forum made up of an equal number of representatives from the creditor and the debtor side, who in turn would appoint a third or a fifth person to act as chair, or judge, of the panel. Such ad hoc panels could begin work now—and would be particularly effective in cases like that of Argentina. With time they would build up a body of practice and law, which could later provide the basis for an international statutory agreement.

BRINGING THE PROPOSAL TO REALITY

The only process needed for the resolution of a debt crisis and the establishment of an ad hoc panel is political will, on the part of both the debtor and G-7 official creditors (who will in turn require the support of private creditors). In doing so, the G-7 creditors will have to overcome the strong incentive of private creditors to resist any proposals for restructuring debts that limit their current control over the process. At the same time the process must respect the rights of creditors by giving them an equal voice in negotiations with the debtor and by not discriminating among them in a way that benefits some creditors and disadvantages others.

A UN resolution may be required to secure the cooperation of UN staff who would provide the independent oversight of the framework and develop principles for determining sustainability levels. Were the G-7 to implement an ad hoc, independent, and transparent process, it would then be able to mobilize the active participation of the IMF for the provision of working capital, known in the U.S. legal code as debtor-in-possession finance. The IMF would thus have its original mandate restored—to provide financial support in crises, and to correct, rather

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than precipitate, imbalances, thereby fostering stability and growth in the international economy.

A review of the history of bankruptcy law in the United States reveals that it was only when rich debtors needed protection from their creditors after the major external economic shocks of the late eighteenth century that a body of law began to evolve that respected the rights of the debtor as well as the interests of the creditor. [12] So long as rich countries are protected from their creditors through, for example, the power to print the currency in which they repay their debts, so long will they be reluctant to develop a just framework for resolving international debt crises. Indeed, it may be that a rich country needs to encounter a major debt crisis before we can expect a new framework to evolve and justice to be achieved in international financial relations. This is regrettable since just, economically efficient, and effective frameworks for resolving debt crises are both feasible and available.

[12] See Bruce H. Mann, *Republic of Debtors: Bankruptcy in the Age of American Independence* (Cambridge: Harvard University Press, 2003).

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Reviving Troubled Economies

Jack Boorman

There would be few dissenters from the general proposition that we should try to deal justly with debt. We have all watched in horror the collapse that has taken place in Argentina and the enormous cost paid by so many people in that country—as well as by the creditors of Argentina—from the massive financial and economic dislocation and disruption. I do not believe that what has occurred was inevitable.

Unfortunately, some who address this issue of dealing with unmanageable debt situations have offered advice that, while emotionally appealing, is not operationally helpful. I will describe and justify the rationale and design of the proposal put forward by the International Monetary Fund for a Sovereign Debt Restructuring Mechanism (SDRM). Its major goal is to help reduce the unacceptably large costs associated with disorderly defaults by sovereign governments whose debt burdens have become unsustainable. The SDRM aims to get the countries' debts to sustainable positions and deal with the broader needs of the countries through the full array of aid and other mechanisms that are available—and, indeed, to enlarge and enhance these initiatives. I will also explain my misgivings about some of the other proposals, including the ones coming from the NGO community.

THE NEED FOR A FORMAL MECHANISM

The dislocation and disorder that occurs when governments default is often the result of reluctance on the part of the countries' authorities to confront the underlying policy problems or to approach the countries' creditors for relief when their debts have become unsustainable. In too many cases, the authorities gamble for redemption through ill-devised policy measures rather than face the uncertainty of approaching the countries' private-sector creditors for the needed relief. Argentina in the summer and fall of 2001 is all too dramatic an example of this phenomenon.

And why are these countries hesitant to approach creditors? One reason for this is reputation: no government official likes to admit the true nature of his or her country's debt problem. Indeed, these officials are often the same people who were partly responsible for the policies that led to the accumulation of that debt. Min-

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isters are also concerned about undermining their countries' future access to capital markets. But, importantly, it is also because at present there is no mechanism to assure that countries that approach their creditors will be able to reach a negotiated settlement with them to restructure the countries' debts in a way that is consistent with their capacity to pay it. Moreover, they have no assurance that the process of negotiating with creditors will be orderly, predictable, and transparent.

In order to address these problems, a proposal was developed in the IMF that has come to be known as the Sovereign Debt Restructuring Mechanism. Five principles guided its development. First, the mechanism should only be used to restructure debt that is determined to be unsustainable. It should neither increase the likelihood of restructuring nor encourage defaults. It must not unduly inhibit the capacity of markets to provide appropriate financing to indebted countries in the future by undermining the presumption of the validity of contracts.

Second, any interference with contractual relations should be limited to those measures that are necessary for resolving the collective action problems that can complicate the process of reaching agreement on a restructuring. The danger is that individual creditors will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors, as a group, would be better served by agreeing to such a restructuring. This problem increases the likelihood of defaults and the large economic and social dislocations that usually follow.

Third, the framework should promote greater transparency in the restructuring process, and encourage early and active creditor participation in it. It should not increase the role of the Fund in this regard.

Fourth, the integrity of the mechanism's decision-making process should be safeguarded by an efficient and impartial dispute-resolution process.

Finally, the SDRM should not expand the Fund's legal powers.

THE SOVEREIGN DEBT RESTRUCTURING MECHANISM

Guided by these principles, the Fund's SDRM proposal was designed with five major features. First, the sovereign debtor would, if needed, have protection from disruptive legal action by creditors during negotiations. This could be provided, in appropriate circumstances, through a stay on litigation, preventing creditors from seeking court decisions for repayment while negotiations are under way. The possible automaticity and the triggers for such possible stays have been widely discussed in the debate on the SDRM. Some favor, similar to the process of domestic bankruptcy, an automatic stay at the time the SDRM is activated. Others see

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this as both unnecessary and possibly counterproductive in certain cases where it would be preferable to continue to service some of the outstanding debt, such as that held by domestic banks.

Second, the creditors would be provided with assurance that debtors will negotiate in good faith and will pursue policies—which will most likely be designed in conjunction with seeking financial support from the IMF—that help to protect the value of creditor claims, to limit the dislocation in the economy, and to limit the likelihood of contagion to other countries. The Fund's policy on lending into arrears is key in this regard.

Third, creditors would be permitted to protect and prioritize fresh private lending during the restructuring process in order to facilitate ongoing economic activity through the continued provision of, inter alia, trade credit (something akin to Chapter 11 debtor-in-possession financing).

Fourth, a supermajority of creditors could vote to accept new terms under a restructuring agreement. If new terms were adopted, minority creditors would be prevented from blocking such agreements or enforcing the terms of the original debt contracts.

Fifth, a dispute-resolution forum would be established to verify the claims of different parties to the negotiation. This forum would assure the integrity of the voting process, and adjudicate disputes that might arise.

A RESPONSE TO THE CRITICS

Some have faulted the proposal because "only private creditors would have to reduce their claims."[1] This is not correct. It is true that the proposal assumes continuance of the preferred creditor status of the IMF and some other multilateral organizations, but bilateral official creditors would be expected to provide relief on their claims on the country. It was always foreseen in the proposal that bilateral official creditors would share the burden, and the Paris Club has been actively examining the implications of this.

A second point that critics make is that the "SDRM would not return poor, indebted countries to viability/sustainability."[2] I believe there is some confusion here: the SDRM is not aimed at the poorest countries. It may be relevant to a few of them that have large amounts of debt outstanding to private creditors (such as

[1] Ann Pettifor and Kunibert Raffer, "Report of the IMF's conference on the Sovereign Debt Restructuring Mechanism, 22nd January, 2003, IMF Headquarters, Washington, D.C." (Jubilee Research at the New Economics Foundation, January 23, 2003); available at www.jubileeresearch.org/latest/sdr220103.htm.
[2] Ibid.

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Nigeria), but for the low-income countries, generally, there is the Highly Indebted Poor Countries initiative—criticism of it notwithstanding.

There are also those in the NGO community who fault the proposal for not including a process through which countries can be discharged of their obligation to repay what they call "odious" debt. While I have no illusions about the existence of odious debt, focusing on it shifts attention away from the real issue: how to deal with the total stock of unpayable debt. The international community has shied away from mechanisms built on concepts such as odious debt and has concentrated on the broader issue. There are various reasons for that. On the political side, some governments, I suspect, may not want to recognize or defend the consequences of lending decisions they have taken in the past and, moreover, may want to protect their future ability to pursue geopolitical ends through international lending. The seriousness of this obstacle is evident from the way in which the initial calls for invoking the concept of odious debt for loans made to Iraq during Saddam Hussein's regime have quickly subsided. On the economic side, dealing with debt in this way could introduce a new source of risk that could seriously affect the workings of the secondary market, where investors exchange government securities among themselves, and hence the ability of sovereigns to mobilize new money. If purchasers in the secondary market had to assure themselves of the integrity of the process through which the claim was originally created, that market would cease to operate.

In addition, there are many questions to be asked about the practicality of the NGO approach with regard to odious debt. Who decides which debt falls into this category? What are the values or criteria to be applied in deciding who ought to bear the costs of dealing with odious debt? For example, if the odious debt deals were cut between one government and another, who should decide, and by what criteria, what balance should be struck between the wronged citizens of the debtor country and the taxpayers of the creditor country who would absorb the cost of the debt relief?

The SDRM has a specific purpose: to help deal with the problems of market-access countries whose debt has become unsustainable, and to establish a system for more orderly and coordinated negotiation between the country and its creditors for debt relief in such circumstances. Interestingly, neither private creditors, who presumably would have to give less relief if odious debt were set aside, nor the emerging market countries themselves have voiced support for this proposal to write off odious debt.

Questions and challenges have also been raised about the role of the IMF under the SDRM. One relates to the appropriate procedure through which the

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SDRM is to be institutionalized. The IMF has proposed that it be created through an amendment to its articles of agreement rather than through a new international treaty. The rationale is straightforward: Helping countries to manage their debt problems and the economic and certain institutional aspects of their interface with international capital markets falls squarely under the IMF's mandate. The SDRM fits within the boundaries of that mandate.

Moreover, creating a new international treaty would likely be a much more complicated and uncertain undertaking. The articles of agreement have been amended before and it is therefore a process familiar to the organization's members. An amendment can take effect immediately when three-fifths of the members having 85 percent of the voting power have voted for it—as opposed to an international treaty, which would require unanimous vote and ratification by domestic parliaments. Amending the IMF's articles of agreement would also provide the framework with greater stability. Withdrawing from a freestanding treaty may have little cost to the withdrawing country. Withdrawing from the Fund, however, deprives the country of the benefits of membership provided for under the articles of agreement.

The amendment would create no new legal powers for the Fund itself. The integrity of the process would be ensured through the Sovereign Debt Dispute Resolution Forum—and this forum would be independent of the Fund.

Apparently most controversial in the eyes of some NGOs and other critics of the proposal is that the Fund would continue to play a role in assessing the sustainability of the country's external position, including its debt. Some criticize this on the grounds that it puts the Fund in the position of dictating the terms of any settlement between the country and its creditors. Others claim that it is incompatible with the role of the Fund as a creditor itself, and, indeed, a preferred one.

However, the Fund has traditionally been treated as a preferred creditor by debtor countries and by other creditors, such as private banks, capital markets, and bilateral official creditors. It is widely accepted that, as the institution providing financing to a country in times of crisis and when other sources of credit have often disappeared, it is appropriate for the Fund to have preferred status. The reason for this is that crisis financing would likely not be forthcoming without that protection. This means that when debt relief is sought, the other creditors must provide a greater share of the needed relief than would be the case if the IMF comparably reduced its own claims. It seems odd that this preferred status of the Fund is accepted as appropriate by most private and official creditors affected by it, while NGOs (which are not so affected) have been opposed to it.

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The Fund has also been criticized for its role in policy formulation and, thus, judgments regarding debt sustainability. Ann Pettifor, for example, claims that the Fund "would play a preemptive role in shaping the outcome of the debt crisis resolution negotiations by setting the country's level of debt sustainability. . . . In addition, the Fund will continue to play a substantial role in shaping the debtor's economic policies. . . . the IMF disempowers the debtor, all other creditors, and civil society" (p. 5). This supposed role of the Fund would certainly surprise anyone who has negotiated a Fund arrangement with a member country. Negotiations are inevitably difficult. They involve extensive discussions, lots of give-and-take, and many concessions from all sides before an agreement is finally reached. The Fund does not ride in with the parameters defining sustainability chipped in stone. There is also no single set of macroeconomic policies dictated by a country's particular condition, even in a crisis situation. There are temporal trade-offs regarding the extent and speed of adjustment, and trade-offs concerning those who need to make the necessary adjustments and sacrifices.

This brings in an important related point rightly emphasized by NGOs: the call for civil society to have a role in the discussions leading to a debt relief plan. The issue, however, is not whether civil society should participate, but through what fora and mechanisms its participation should be organized. In turn, this relates to how policies and debt sustainability are determined. The government budget is the key instrument of policy in this regard, since it is the basis on which debt service capacity will be determined. And, contrary to the views of some in the NGO community, the country's budget is not dictated by the IMF. Increasingly, the countries with which the IMF has arrangements are democracies in which the budget comes out of a process of consultation between the government and the national parliament that determines the overall framework of the budget, spending priorities, judgments about taxing capacity, and all the other aspects of the final budget presentation. The Fund is part of that process through its discussions with the government. Civil society should certainly be part of that process as well, through representations to the government, participation in parliamentary debate, the giving of testimony, lobbying, and all other means traditional to the specific culture of each country. Effective participation and transparency for civil society are thus required in the domestic system. If these are assured, the process of establishing the trade-offs that ultimately help to determine debt sustainability holds the promise of being fair and effective.

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If the world is going to deal justly with debt, it needs to prevent debt crises from occurring in the first place—and many of the initiatives in the Fund and elsewhere are aimed precisely at that objective. Stronger economic and financial policies combined with improving the environment for private-sector decision-making in ways that facilitate the assessment and management of risk offer the best prospect for allowing countries to reap the potential gains from globalization, while minimizing the likelihood, and potential severity, of crises. Robust assessments of the strength and soundness of banking systems and a country's financial system more generally; encouragement of the adoption of internationally recognized standards and codes and of best practices in numerous areas of economic policymaking and institution building; and better surveillance or monitoring of country policies by the authorities themselves, as well as by the IMF, are all part of these efforts. Nevertheless, crises will occur, and we need to find a way that allows for dealing with them at an early stage in order to alleviate the enormous costs they involve for the citizens of the debtor country and its creditors. I believe the SDRM holds that promise.

The SDRM proposal has been formulated in rather specific terms in a statement from the managing director to the Fund's governing body, the International Monetary and Financing Committee, and has evolved as a result of the most ambitious consultative process that the Fund has ever engaged in, including the official sector, bankruptcy practitioners, the international legal community, NGOs, and many others. These consultations have led to many important modifications in the proposal. They have also contributed to a greater understanding of the legal and institutional complexities involved in debt restructuring. Even if the SDRM is never implemented, which would be regrettable, it has advanced the debate concerning debt restructuring in important ways. It has given new impetus to the push in the official community that began in the mid-1990s with the Rey Report to encourage the use of collective action clauses (CACs) in sovereign debt issues. Similarly, there is now widespread agreement—at least in principle—on the desirability of agreeing on a voluntary code of good conduct. Although it would not solve collective action problems, such a code would, among other things, foster greater transparency, provide guidance to debtors and creditors regarding procedures for contact and negotiations, and help to provide greater predictability to the restructuring process under any legal framework. Such a code could be made applicable to a broad set of circumstances, ranging from periods

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of relative tranquility to periods of acute stress, and could constitute an established set of best practices. In that way, it would enhance the proposals for strengthening arrangements for debt restructuring, which have the more limited scope and purpose of facilitating the resolution of financial crises.

These discussions are already generating change in the financial markets. For example, Mexico, South Africa, and Korea, among other emerging market countries, have recently included collective action clauses in sovereign bond issues. A system with reasonably comprehensive and robust CACs and a well-defined code of conduct with broad support among debtors and their creditors will be an improvement on the system that currently exists. Nevertheless, I believe the role of these initiatives should be complementary to the SDRM. They are not sufficiently powerful by themselves to provide what is needed to deal with the more complex and potentially damaging crises that may occur. The past few months have seen a number of news articles speculating on the future of the SDRM. Some have hinted—in my view, prematurely—at its death. However, it took many years to enact bankruptcy legislation in the United States and I believe more work and more thinking is called for—and that is what has been requested by the International Monetary and Financing Committee.

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The Constructive Role of Private Creditors

Arturo C. Porzecanski

During the past couple of years, policy-makers in Washington and other capitals of G-7 countries have been flogging the idea that the functioning of the world's financial markets must be improved by making it easier for insolvent governments, especially in emerging markets, to obtain debt relief from their bondholders and bankers.

Most savvy investors, financial intermediaries, and emerging-market government officials, however, are at a loss to understand why the G-7 and the International Monetary Fund (IMF) believe the international financial system would function better if there were specific mechanisms to facilitate sovereign bankruptcies.

The main reason U.S.–chartered corporations that cannot pay their creditors subject themselves to wrenching reorganizations before entering into, or once under, Chapter 11 of the U.S. bankruptcy code is that the alternative is their outright liquidation under the code's Chapter 7. Sovereign governments, in contrast, do not operate under the threat of liquidation, and despite the strong rights that bondholders have on paper under New York, British, and other law, practical experience indicates that the enforcement of claims against sovereign governments is exceedingly difficult. Whereas delinquent corporations can be hauled, de jure and de facto, before a bankruptcy court and be forced to change management, restructure operations, dispose of assets, or even liquidate to pay off claims, governments are not subjected to any of that. Chapter 9 of the U.S. bankruptcy code is similarly unhelpful as a model for how to restructure the liabilities of bankrupt governments, since it does not apply to sovereign entities, such as U.S. states and counties, which under the U.S. Constitution are ensured to remain free of federal government interference.[1]

Consequently, those in the business of issuing, underwriting, or investing in sovereign bonds are generally of the view that, if anything, international reforms should focus on making contracts easier to enforce and on facilitating the constructive involvement of bondholders and other private-sector creditors in debt-

[1] Chapter 9 applies to nonsovereign entities such as municipalities, school districts, and publicly owned utilities. For a discussion of why Chapter 9 provides little guidance in the case of sovereigns, see Michelle J. White, "Sovereigns in Distress: Do They Need Bankruptcy?" *Brookings Papers on Economic Activity* 1 (2002), pp. 287–319.

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restructuring negotiations.[2] Yet the G-7 has not called for any actions or penalties against irresponsible governments, such as the attachment of their official international reserves when they are on deposit with central banks like the U.S. Federal Reserve or with the Bank for International Settlements, the central banks' central bank. At present, for example, the investors who have filed suits against Argentina in New York and other jurisdictions because of the default that took place more than a year and a half ago cannot get their hands on the billions of dollars that the government of that country has sheltered in those G-7 institutions. The G-7 initiatives have not contemplated any incentives—let alone principles or procedures—for ensuring that governments become more accountable for their financial obligations.[3] The intent of the initiatives is wholly one-sided: to expedite the granting of debt relief on the part of bondholders and other private-sector creditors.

THE RECORD SPEAKS

Although various proposals for resolving debt crises have been advanced, they all suppose that the lack of collective action among private-sector lenders and investors is the main obstacle to the smooth functioning of the international financial system.[4]

Yet there is little if any empirical support for this claim. On the contrary, private creditors have been much more progressive, flexible, and quick in dealing with sovereign insolvency situations than have been official lenders—and the gap in their different responses is growing. In fact, private lenders have provided a good example for how official bilateral and multilateral lenders might themselves deal more fairly and effectively with sovereign insolvency situations.

The absence of innovative mechanisms has not impeded several landmark workouts of sovereign indebtedness. The governments of Ecuador, Pakistan, Russia, and the Ukraine, for example, have all been able to restructure their bonded

[2] See, e.g., Institute of International Finance, Inc., "Principles for Private Sector Involvement in Crisis Prevention and Resolution" (Washington, D.C.: Institute of International Finance, Inc., January 2001); available at www.emta.org/ndevelop/iif-psi.pdf.

[3] Nor, of course, have they even mentioned the idea of subjecting troubled debtor governments to outside intervention of the type that New York City, for example, had to accept when it could not pay its bills in the early 1970s.

[4] According to the first deputy managing director of the IMF, a new approach to sovereign debt restructuring is needed because "in the current environment, it *may* be particularly difficult to secure high participation from creditors as a group, as individual creditors *may* consider that their best interests would be served by trying to free ride . . . . These difficulties *may* be amplified by the prevalence of complex financial instruments . . . which in some cases *may* provide investors with incentives to hold out . . . rather than participating in a restructuring" [emphasis added]. See Anne O. Krueger, *A New Approach To Sovereign Debt Restructuring* (Washington, D.C.: International Monetary Fund, April 2002), p. 8; available at www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf.

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debt in recent years—and have done so in record time. Substantial debt-service relief and even sizable debt forgiveness have been obtained through the use of exchange offers, often accompanied by bondholder exit consents that encourage the participation of as many investors as possible in take-it-or-leave-it settlements. Rather than amending bond covenants, the exchange offers typically entail the debtor government presenting its private creditors with a menu of voluntary options, such as accepting new bonds for a fraction (for example, 60 percent) of the principal owed but paying a market interest rate, or new bonds for the original principal but paying a concessional interest rate. Experience has demonstrated that neither the threat of litigation nor actual cases of litigation have obstructed these debt restructurings, which have involved large, institutional as well as small, retail investors throughout the world.[5]

The latest case involves the government of Uruguay, which earlier this year asked investors to consider a debt-restructuring request, and more than 90 percent of them agreed, enabling the operation to be consummated in a matter of several weeks.[6] The Uruguayan authorities previously spent many months debating the nature of the restructuring with the IMF. The IMF wanted Uruguay to default on its obligations to bondholders just like Argentina had done, with the intention of obtaining massive debt forgiveness from private creditors, but the Uruguayan authorities refused to go down this potentially ruinous path. The government wanted to pursue, instead, a market-friendly debt exchange with the sole purpose of stretching out the maturities falling due in 2003 and the next several years, while respecting the original amounts owed and continuing to make the requisite interest payments. It was only after the Uruguayan authorities sought and obtained support from the U.S. Treasury and the Federal Reserve that the IMF staff backed down and agreed to support a voluntary debt exchange.[7]

Once an understanding between the IMF and Uruguay was reached, matters moved rather quickly. Informal discussions with private creditors were held in March of this year, a concrete proposal was put forth in April, investor replies were received in May, and by June Uruguay's bonded debt had been successful-

[5] For useful background information on sovereign debt defaults and restructurings, see World Bank, *Global Development Finance 2003: Striving for Stability in Development Finance*, vol. 1 (Washington, D.C.: World Bank, 2003), pp. 56–79; available at www.worldbank.org/prospects/gdf2003/GDF_vol_1_web.pdf.

[6] See the statement by the U.S. attorneys for Uruguay, Cleary, Gottlieb, Steen & Hamilton, "Uruguay in Groundbreaking $5.2 Billion Debt Restructuring," Press Release, May 29, 2003; available at www.cgsh.com/newsworthy-categories.cfm?strNwsCatName=Restructurings.

[7] See the TV interview with President Jorge Batlle of Uruguay, "El Default Significaba el Quiebre Institucional de Uruguay," July 4, 2003; available at www.presidencia.gub.uy/sic/noticias/archivo/2003/julio/2003070404.htm. This version of events had previously been revealed by Vice President Luis Hierro of Uruguay, but had been denied by the IMF's spokesman; see IMF, "Transcript of a Press Briefing by Thomas C. Dawson," June 26, 2003; available at www.imf.org/external/np/tr/2003/tr030626.htm.

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ly restructured. This was accomplished despite the fact that the investor base was scattered around the globe: the operation involved from retail investors in Argentina and Japan to institutional investors in the United States and Europe, all of whom were bound by contracts written in several jurisdictions, each with its own currency and distinct legal features.

The cases of Bolivia, Nicaragua, and Ecuador, with which this author had some involvement, highlight the difference between how private and official creditors have treated governments in serious financial trouble. Back in 1988, commercial bank creditors first forgave nearly 90 percent of what the government of Bolivia owed them, and in 1993 they wrote off nearly 85 percent of the then-remaining principal.[8] In contrast, the country became eligible for debt relief from official bilateral and multilateral creditors under the original Highly Indebted Poor Countries (HIPC) initiative a full decade later, in September 1998, and under the Enhanced HIPC initiative only in June 2001.[9]

In 1995, commercial bank creditors forgave more than 90 percent of what the government of Nicaragua owed them. In contrast, official bilateral creditors represented by the Paris Club canceled less than 55 percent of the outstanding obligations at about the same time, with no debt relief coming from the multilateral agencies. The country never became eligible for debt relief under the original HIPC initiative, and will not qualify for the benefits of the Enhanced HIPC initiative prior to 2004, although the Paris Club creditors recently agreed to cancel the equilvalent of one-fourth of Nicaragua's remaining debt obligations.[10]

In 1995, private creditors also granted a mix of debt and interest forgiveness to the government of Ecuador, as part of a comprehensive Brady-style settlement. Creditors accepted the choice of either writing off 45 percent of the principal owed while stretching out the maturity dates for repayment of the remainder for thirty years, or charging highly concessional interest rates for thirty years. The holders of nearly 60 percent of the total debt chose to provide principal relief, while the remainder chose to provide long-term interest-rate forgiveness. When Ecuador experienced acute economic difficulties again in 1999, the IMF made it clear to the government that it would not get any help from the official community unless it

[8] For a detailed discussion of this and the following cases, see Institute of International Finance, Inc., "Survey of Debt Restructuring by Private Creditors" (Washington, D.C.: Institute of International Finance, Inc., April 9, 2001), p. 5 (Bolivia), pp. 21–23 (Ecuador), and p. 45 (Nicaragua).
[9] On HIPC relief for Bolivia and other countries, see World Bank, "HIPC Initiative: Status of Country Cases Considered Under the Initiative, April 2003," April 2003; available at www.worldbank.org/hipc/progress-to-date/status_table_Apr03.pdf.
[10] See Paris Club, "The Paris Club and Nicaragua Agree to a Debt Restructuring under the Enhanced Heavily Indebted Poor Countries Initiative," Press Release, December 13, 2002; available at www.clubdeparis.org/rep_upload/PR01.pdf.

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defaulted to private creditors and obtained debt forgiveness once again.[11] Shut out of IMF and other official financial support, the government had no choice but to declare a default. Before long, Ecuador's bondholders were formally requested to grant permanent debt relief—and by August 2000 they had forgiven about 40 percent of what was owed to them.

In contrast, official bilateral and multilateral lenders have not granted any debt forgiveness to Ecuador. The country was deemed by the IMF to be insolvent enough to deserve write-offs from private creditors—but not poor enough to deserve write-offs from the official development community. Paris Club creditors have therefore agreed merely to reschedule about one-third of debt-service payments falling due between May 2000 and May 2001 and between March 2003 and March 2004 according to the Houston Terms, the least generous of all Paris Club poor countries' debt treatments. Thus Ecuador has continued to be charged mostly market interest rates and is expected to repay the bulk of its obligations as they mature.[12] Meanwhile, it is still business as usual at the multilateral agencies: they have not rescheduled, never mind forgiven, any of Ecuador's debt, and they have provided little new money. In fact, from 2000 to 2002, amortization payments by Ecuador to the multilateral agencies exceeded disbursements from those agencies.[13] Once interest payments made to the multilateral agencies are factored in, it becomes clear that Ecuador has made substantial net transfers to the official community.

THE G-7'S UNDERLYING RATIONALE

What then is the rationale of the G-7 and the IMF in devoting so much time and effort to facilitating future workouts of sovereign debt to private creditors? Apparently, G-7 and IMF officials are trying to ameliorate the undesirable consequences of their recent practice of bailing out certain troubled sovereign debtors with multi-billion-dollar rescue packages. Stung by criticism of these bailouts, and worried about having encouraged too many countries with looming debt crises to come knocking at their door pleading for last-minute help, the G-7 governments have

[11] This is based on frank, off-the-record conversations with IMF and Ecuadorian officials. For the IMF's version of the events, see Stanley Fischer, "Ecuador and the IMF," May 19, 2000; available at www.imf.org/external/np/speeches/2000/051900.htm.

[12] See Paris Club, "The Paris Club Agrees to a Debt Restructuring for Ecuador," Press Release, September 15, 2000; available at www.clubdeparis.org/rep_upload/ec15092000cpen.pdf; and Paris Club, "The Paris Club Agrees to a Rescheduling of Ecuador's Debt," Press Release, June 13, 2003; available at www.clubdeparis.org/rep_upload/PR0123.pdf.

[13] See International Monetary Fund, "Ecuador: Selected Issues and Statistical Appendix," IMF Country Report No. 03/91, April 2003, p. 112; available at www.imf.org/external/pubs/ft/scr/2003/cr0391.pdf.

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wanted to open up an alternative for themselves—a fast track to default, debt forgiveness (at least by private lenders), and financial resurrection. Thus, when in the future an overindebted government that is not strategically important approaches the G-7 for emergency financial help, it will no longer be able to claim that it must get billions of dollars because the alternative is a hopelessly disruptive, delayed, and uncertain default with potential spillover effects around the globe. With some kind of sovereign bankruptcy procedure in place, the G-7 would feel freer to tell that government to seek debt forgiveness from its private creditors, instead, on the belief that a relatively painless and quick debt restructuring would follow.

From late 2001 until early 2003, the IMF staff worked feverishly on a proposed Sovereign Debt Restructuring Mechanism (SDRM) that, however, has not yet gained the necessary political support among a number of governments, including the United States. Its earlier versions envisioned a powerful role for the IMF that would have allowed it to make decisions limiting creditors' rights. In the face of universal criticism from private-sector lenders and investors, the IMF's role was later toned down to the equivalent of the sole expert witness, by passing judgment on how much debt any government could reasonably be expected to service. In this capacity, the IMF and its G-7 shareholders on its executive board would have a procedural advantage that would allow them to protect their claims and influence the amount of debt relief granted by private creditors.

The planned SDRM was not accompanied, however, by a proposal to address what has really undermined the functioning of the international financial system in recent years: the multibillion-dollar G-7 and IMF rescue packages that have been put together for strategically important countries since 1995. Thanks to the string of bailouts involving countries from Mexico to South Korea, and from Brazil to Turkey, the possibility that a country may get a huge package of financial support with which to meet its debt obligations has become one of the key elements in the assessment of sovereign creditworthiness. Many credit ratings, analyst recommendations, and investment decisions are based on assumptions about whether a foreign government is viewed with favor by the White House, Downing Street, or another G-7 government. The situation is akin to picking stocks or bonds for a portfolio not on the basis of whether a weak company will manage to turn itself around, but rather on whether it will be nursed back to health via an infusion of large-scale government support. How could the U.S. financial markets possibly function well if state intervention, as in the case of the Chrysler bailout of 1979–80, had become commonplace?

A counterproposal put forward by the U.S. Treasury and endorsed by many investors and financial intermediaries is a much better alternative. It represents a

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contractual rather than statutory approach to sovereign bankruptcy situations, involving the introduction of new clauses into bond contracts to facilitate the debt restructuring process. The main idea is that every bond contract should designate a bondholder representative to act as an interlocutor with the sovereign debtor; require the sovereign to provide more key financial information to its bondholders; allow for a supermajority of bondholders to amend payment terms, now often requiring unanimity of consent; and include enforcement provisions that concentrate the power to initiate litigation in a single jurisdiction.[14] These new clauses have become widely known as collective action clauses (CACs), and while several already exist in bonds issued under U.K. law, most new and outstanding bonds of emerging-market sovereigns are issued in other jurisdictions, such as New York and Frankfurt, where such clauses are not customary.

Most emerging-market issuers and investors were initially reluctant to introduce CACs in new bond contracts for fear of signaling that they contemplate or countenance an eventual default. Besides, even if such clauses are introduced voluntarily in all new debt issues, the stock of outstanding bonds would still be governed by preexisting legal arrangements, so that their practical effect will be marginal for years to come. Under strong pressure from the U.S. Treasury, however, the governments of Mexico and Brazil were persuaded earlier this year to issue new bonds with CACs, and they were successfully placed with institutional investors at no measurable extra cost. Governments such as those of South Africa and South Korea followed suit, although each sovereign bond issued so far carries its own particular clauses that do not incorporate all of the language recommended by official and private-sector groups. Consequently, a uniform market standard in CACs is yet to develop.

While wider inclusion of CACs into sovereign bond contracts will probably do no harm, it is doubtful that even their widespread application will make a visible difference to the workings of international finance. Of much greater significance would be a G-7 decision to scale back the massive official support to certain errant debtor nations. If the IMF were to go back to providing seed money for economic and policy turnarounds on as objective a basis as possible, this alone would encourage governments and their creditors to consider much more seriously the implications of falling into the abyss of default—regardless of whether improved sovereign bankruptcy mechanisms are instituted. Moreover, it is patently unfair that some governments should be lavished with official aid and others should be

[14] See Group of Ten, "Report of the G-10 Working Group on Contractual Clauses," September 26, 2002; available at www.bis.org/publ/gten08.pdf.

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starved, when the IMF is supposed to be a cooperative to which its member governments should be able to turn for fairly automatic, albeit limited, help.

In addition, the very notion of a quick and painless debt restructuring is problematic both on an ethical and practical level. Ethically there should not be, I believe, such a thing as a fast track to default, debt forgiveness, and financial resurrection. The smoother the road to sovereign bankruptcy, the more likely it is that governments will exhibit lack of fiscal discipline and "reform fatigue," squandering the proceeds of borrowed hard currency, in the knowledge that, if worse comes to worst, they can obtain a financial pardon. In practice, it is not possible to obtain massive debt forgiveness via quick and painless debt restructurings. The recent tragedy in Argentina, for example, would not have been avoided if the SDRM or the CACs had been in place in 2001. Because a substantial proportion of the Argentine government's debt obligations was held by local banks, pension funds, and insurance companies, any announcement of a payments standstill with the intention to seek meaningful debt forgiveness would surely have triggered a stampede of bank depositors and a collapse of the pension and insurance industries. This would have led to a run on the central bank's official reserves, precipitating a devastating currency devaluation and thus the same economic implosion, political fallout, and popular discontent that were witnessed in late 2001 and early 2002.

In conclusion, bondholders and commercial and investment banks in the U.S. and Europe should be recognized rather than castigated for their track record in dealing with sovereign debt problems. They have helped to resolve expeditiously and even generously the sovereign debt crises in which they have been involved in various parts of the world, especially in recent years. The official development community cannot make a similar claim.

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Sovereign Debt Restructuring Proposals: A Comparative Look

*Thomas I. Palley**

A range of different solutions, as the contributions to this roundtable show, has been proposed regarding the problem of sovereign borrower insolvency. Two prominent factors need to be taken into account in assessing the merits of each proposal: its impact on economic efficiency, in particular on the supply and price of credit for developing countries, and its regard for considerations of justice and procedural fairness.

UNDERSTANDING THE PROBLEM

The last twenty years have been marked by significant changes in the pattern of international financial flows to developing countries. First, there has been a dramatic shift from official development assistance to private capital flows. Second, within private capital flows there has been a shift away from syndicated bank lending to bond lending. The former involves lending by groups of banks, whereas the latter involves issuance of bonds that may be held widely by multiple types of financial institutions and retail investors. This shift has given developing countries access to more capital and a richer menu of financing choices. However, access to more credit has also been accompanied by the buildup of overindebtedness, with negative consequences for credit markets and the global economy. As a result of the increased reliance on private-sector bond financing, financial markets may now have greater difficulty arranging debt restructurings at a time when they are needed more frequently.

The buildup of large debts generates a debt overhang that creates a permanent climate of financial fragility. Given this climate, lenders require higher interest

* For an extensive discussion of some of these issues, see also my paper, "The Economics of Sovereign Debt Restructurings: A Comparison of Competing Proposals and a Suggested Compromise" (Open Society Institute, 2003, unpublished). This essay has benefited from the comments of the participants at seminars held at the IMF, Washington, D.C., September 27, 2002, and January 22, 2003; the consultative seminar, "UN Financing for Development," United Nations, New York, N.Y., November 7, 2002; and the roundtable, "Dealing Justly with Debt," Carnegie Council on Ethics and International Affairs, New York, N.Y., April 30, 2003. The views expressed are mine, and not those of the Open Society Institute.

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rates to compensate for risk of default, which raises the price of investment finance and in turn debilitates economic development. Existing debts also obstruct countries from obtaining new investment finance, even for projects that may have high marginal rates of return.

Countries' inability to restructure debt also has negative impacts on global credit markets. Under the existing system, the costs of default to a domestic economy are large, and countries have an incentive to "gamble for redemption"—take high-interest loans to repay pending ones, while hoping that something will happen that will prevent the escalation of debt and help them to avoid default. For their part, private creditors actively support this gambling by agreeing to lengthen repayment schedules in return for higher interest payments. The International Monetary Fund (IMF) also partakes in this process of gambling for redemption by extending loans to head off default. It does so because of the potential large costs for the global financial system, since default in one country can trigger financial crisis in another. To avoid these costs of financial contagion, the IMF often steps in to provide financing, thereby effectively bailing out private lenders. This adds another problem to the efficient functioning of credit markets—the moral hazard that prompts private lenders to factor expectations of a bailout into their lending decisions.

A second set of problems concerns the existing debt restructuring process. Currently, debt restructuring negotiations under the arrangements of both the Paris Club, which deals with debt owed to official-sector creditors, and the London Club, which deals with debt owed to private-sector creditors, are long and uncertain, and their outcomes are less than comprehensive. The lack of default protection for new lending during restructuring negotiations may result in under-provision of new financing that is necessary to fund investment, which drives economic growth. In effect, the current system has no equivalent for countries of debtor-in-possession financing under the private-sector bankruptcy code. Another difficulty is the collective action problem that arises because individual creditors have an incentive to act in their own perceived self-interest, which can result in collectively suboptimal outcomes. Thus, if one creditor holds out for full repayment during restructuring negotiations, or decides not to participate in them at all and instead files suit in court against the debtor, this may end up reducing the ultimate payment to each creditor. Still worse, the collective action problem applies not just within a specific creditor class, but also across creditor classes since different classes must agree upon the debt restructuring package. When development finance was provided through syndicated bank loans, the mentality and intimacy of the bankers' club prevailed, making it easier to negotiate loan-

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restructuring agreements. In addition, domestic banking authorities were able to exert subtle pressures to get banks to cooperate. This no longer holds given today's reliance on bond market financing.

STAYING OUT OF MARKETS

At one end of the spectrum of the proposed solutions is the private-sector view that the existing international credit markets are actually functioning fairly well. There is no significant collective action problem, and in many instances private creditors have been able to arrange debt restructurings efficiently. The only disruption is moral hazard created by the IMF's policy of bailing out countries with unsustainable debt.

However, this view is challenged by the recent experience in Argentina, which has suffered enormous income losses as a result of the deadlock caused by its default. Supporters of sovereign debt restructuring arrangements maintain that these losses could have been far smaller had a formal restructuring system been available. Their argument is that instead of entering a chaotic, prolonged default marked by the cutoff of international credit, Argentina would have been able to establish an orderly process that could have allowed for earlier normalization of relations with capital markets. This in turn would have reduced the scale of Argentina's recession.

Additionally, though restructuring of Ukraine's private-sector debts was accomplished, this restructuring was extended and difficult, which contributed to uncertainty that harmed investment and growth. Debt restructuring might have been accomplished with greater speed and less cost had a formal mechanism existed.

These cases attest to the fact that international financial markets have changed in ways that make restructurings more difficult to accomplish—hence the need for formal sovereign debt restructuring arrangements. Iraq offers the prospect of another instance where a sovereign debt restructuring might prove useful—and interestingly, most of Iraq's debt is official, which speaks to including official debt in the restructuring mechanism, as proposed by NGOs.

THE CONTRACTUAL SOLUTION

Another private-sector view, in partial recognition of these difficulties, is that international bond markets need modest tweaking in the form of introducing collective action clauses (CACs) into bond contracts. These clauses will bind all

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bondholders by the decision of a supermajority, thus allowing bondholders as a group to protect against individual holdouts.

CACs are a useful tool for improving collective action on the part of bond creditors, and they stand to facilitate debt restructurings. However, there is widespread agreement that they do not solve the core problems. In particular, CACs only bind holders of a single bond issue—hence the aggregation problem of binding bondholders across different classes remains. Nor do CACs address the problem of coordinating creditors across different jurisdictions where debt is issued. For instance, a country may borrow on the New York and London markets, and bankruptcy courts in the two jurisdictions may impose differential rulings. Further, absent binding international agreement or external pressure, debtors may be unwilling to issue new debt with CACs since creditors may view the clauses as weakening their rights and demand a higher risk premium. Finally, CACs would only apply to new debt that is issued with them. This leaves unaddressed the problem of the massive stock of already existing debt.

THE STATUTORY APPROACHES OF THE IMF AND NGOS

The IMF's Sovereign Debt Restructuring Mechanism (SDRM) and the NGO-endorsed Chapter 9 proposal both take a more comprehensive approach that envisions an institutional framework for resolving debt crises. They do so in the recognition that the dramatic changes in international financial markets render the existing system of ad hoc workouts ill equipped to address the negative economic and social consequences that arise from debt defaults. Despite this common feature, the two approaches have important differences regarding the details of the institutional mechanism. These differences result from disagreement over the economic consequences of alternative arrangements, as well as disagreement over the goals of debt restructuring. In particular, the IMF's perspective has always been one of improving capital market efficiency. Contrastingly, the NGO community has been significantly motivated by a desire to cancel corruptly accumulated debt of developing countries, which are poor and burdened by massive interest payments to rich countries.

The IMF's SDRM envisages a voluntary negotiation between the debtor country and its creditors, taking place in the Sovereign Debt Dispute Resolution Forum (SDDRF). A settlement would require a 75 percent supermajority approval by each class of recognized creditors. The details of these classes remain to be spelled out but could include official bilateral creditors (if official debt were included),

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privileged creditors, unsecured creditors, and a special optional class category that could be invoked in special circumstances if the structure of claims warranted it.[1]

From the IMF's perspective, market efficiency stimulates economic development, which promotes well-being. Hence it would be economically misguided and ethically wrong to push for reforms in a way that raises the cost and lowers the supply of development finance. The SDRM was designed with these considerations in mind, and there are significant economic benefits to it. First, since all private-sector debtors are involved in a coordinated manner, the restructuring procedure should be more orderly and accelerated, thereby reducing the economic damage that follows from default. Second, to the extent that it facilitates more comprehensive restructuring, it should help countries to escape the debt overhang problem and resume growth—which will benefit both the debtor country and the global economy. Further, with the available option of declaring insolvency and filing for bankruptcy, debtor countries would not have to gamble for redemption, and the IMF will no longer feel pressured to bail them out in order to avoid international financial contagion—which, in turn, would remove the moral hazard problem.

However, the IMF proposal explicitly excludes debts owed to the IMF and other multilateral institutions.[2] Consequently, debt restructuring within the SDRM stands to be incomplete, which stands to reduce the economic effectiveness of the SDRM. Further, the lack of an automatic stay on creditor enforcement may provide an incentive for individual creditors to pursue legal action outside the SDRM framework to obtain full value.[3] The absence of a stay also means that the debtor country will be formally in default if it ceases making payments, thereby preventing reversion to the status quo ante if the negotiations come to nothing––a feature that may give creditors a bargaining advantage in the SDDRF. Finally, the SDRM only gives legal standing to the debtor country and the creditors. It gives no standing to citizens either to express their views on the legitimacy of debts or on the particulars of any negotiated settlement. This is problematic given the prevalence of corruption and lack of democracy in many developing countries.

The Chapter 9 International Bankruptcy Court proposal, inspired by the section of the U.S. bankruptcy code that deals with bankruptcies of municipalities, rests on binding arbitration––in contrast to the voluntary negotiation of the

[1] International Monetary Fund, "The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations," November 2002, paras. 183–208, pp. 48–53; available at www.imf.org/external/np/pdr/sdrm/2002/112702.pdf.
[2] Ibid., paras. 188, 16, pp. 49, 9.
[3] The SDRM does allow for a stay of enforcement provided that 75 percent of the creditors consent.

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SDRM.[4] As with the SDRM, the debtor would trigger the process by filing for bankruptcy. However, at this stage three judges would be impaneled—one selected by the debtor, another by the creditors, and a third by mutual agreement of the debtor and creditors.

The Chapter 9 approach has two major economic strengths. First, it explicitly includes all debts—official, private, and multilateral—potentially allowing for the full resolution of the debt overhang problem. In one step, the procedures of the Paris Club and the London Club, and that of the Highly Indebted Poor Countries initiative, are consolidated under one roof, and problems of aggregation are voided.

Second, it allows for citizen input during the initial debt verification stage, when citizens could request the invalidation of debts classified as odious—that is, debts for which lenders could have reasonably been aware were being incurred by internationally unrecognized regimes to finance expenditures that were not for the benefit of the people. The odious debt provision could potentially remove the significant economic efficiency losses that occur at present because of corruption and theft that benefits governing elites at the expense of country development. Knowing that loans could be disqualified in a Chapter 9 proceeding, lenders would have an incentive to lend only to honest regimes, and to monitor closely their loans to ensure that the funds were honestly used. Not only would such monitoring raise the rate of return on investments by ensuring that funds were properly spent, it would also counter the corruption and financing of conflict that have been so disastrous for economic development. Moreover, developing country governments would have an incentive to address corruption in order to gain legitimacy and lower their borrowing costs.

The Chapter 9 model explicitly gives standing to citizens' voices within the court process in two other ways: the entire process is intended to be fully transparent, with court proceedings open to the public, and citizens could conceivably be asked to approve the negotiated settlement by referendum. The IMF argues that this feature would place an unnecessary burden that would slow the debt resolution process; citizen input should rather be assured in the domestic process through which citizens elect and shape the agenda of their representatives to multilateral organizations. Although this may be true in theory, in practice many of the countries with serious debt problems do not have democratic governments or are young democracies with undeveloped institutions and civil society. As a result,

[4] The Chapter 9 approach was originally proposed by Kunibert Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face," *World Development* 18, no. 2 (1990), pp. 301–13.

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the venues for citizen participation in their domestic policy processes are either absent or inadequate.

One significant cost to the Chapter 9 approach is that it represents a considerable alteration of creditor rights that could have major negative ramifications for the supply and price of capital for developing countries. The prospect of binding arbitration with debtors appointing 50 percent of the judges, and the possibility for odious debt cancellation, could frighten potential lenders. This could dramatically reduce the supply of credit to developing countries while raising the interest rate charged, at least in the short term until lenders learn to protect themselves against the risk of odious debt cancellation through due diligence and by application of restrictive covenants that ensure loans are used as intended.

A second difficulty concerns the development of an operational concept of sustainable debt. Such a concept is needed to guide the judges regarding the provision of debt relief. Though the notion of sustainable debt is clear in principle, in practice it is much harder to define.[5] Contrastingly, the SDRM proposal could be operational without a definition of sustainability because debt resolution is achieved through consensual negotiation between the debtor country and its creditors.

Finally, there is concern that the selection of judges discriminates against sovereign creditors. Whereas sovereign debtors get to appoint half of the judges, sovereign creditors are not given equal rights. This constitutes an asymmetric treatment of sovereigns, with sovereign debtors being given preferential treatment relative to sovereign creditors.

A MODIFIED SDRM

From an economic standpoint, the comprehensive approach of an institutional mechanism holds the promise of being effective in dealing with debt. From a political standpoint, creating such a mechanism will require wide support. An irreconcilable difference between the SDRM and Chapter 9 proposals concerns the distinction between voluntary negotiation and binding arbitration. However, in other regards the SDRM proposal can be modified to render it closer to the spirit and intent of Chapter 9.

The first important modification would be to include an automatic stay of creditor enforcement. This is important in order to protect debtor interests and

[5] For a detailed discussion of the different ways of defining sustainability, and the problems related to forecasting future economic growth, see International Monetary Fund, "Debt Sustainability in Low-Income Countries: Towards a Forward-Looking Strategy," May 2003; available at imf.org/external/np/pdr/sustain/2003/052303.pdf

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to give creditors an incentive to negotiate in good faith within the SDRM process. The IMF dismisses the inclusion of this provision by claiming that, in practice, creditors will not have time to collect on any enforcement actions within the envisaged SDRM negotiation timeframe, making such a stay irrelevant.[6] However, if this is the case, then the IMF and the creditors should have no objection to its inclusion.

Second, to make the restructuring comprehensive and thus effective, and to assure that private and official creditors are treated justly, the debt owed to the official community and the IMF should be included under the SDRM. Exception should be made only for new, debtor-in-possession-style lending that the international financial institutions provide as vital finance to the debtor country while negotiations are under way. Indeed, there is a benefit to be derived for official creditors from a comprehensive approach: they would gain significant control over the process, particularly if official and private debts were put in one class. Because an agreement will require a 75 percent supermajority, official creditors, who would often hold more than 25 percent of the outstanding debt, would effectively hold a veto in many instances.

In addition to making for comprehensive restructuring, inclusion of IMF and multilateral institution debts would also nullify existing private-sector creditors' objections that they are being asked to bear all the burden of debt restructuring. Finally, including the debt owed to the IMF and other international financial institutions would contribute to improved market efficiency by removing the moral hazard. If these loans were not protected, the IMF's incentive to finance bailouts of overindebted countries would be significantly reduced.

[6] Moreover, under the "hotchpot" rule, any legal takings outside the SDDRF would be deducted from the creditor's entitlement under the SDDRF settlement. The hotchpot rule says that any funds collected by an individual creditor enforcement action in another jurisdiction shall be netted out of the share due that creditor in the jurisdiction where the bankruptcy case is being heard. As such it is a disincentive to individual creditor enforcement actions, which is why the IMF argues a generalized stay of enforcement is not needed.

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