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Why the Code of Conduct for Resolving Sovereign Debt Crises Falls Short

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Task Force on Debt Restructuring and Sovereign Bankruptcy

WHY THE CODE OF CONDUCT FOR RESOLVING SOVEREIGN DEBT CRISES FALLS SHORT

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1. INTRODUCTION

What process should be followed to help governments with foreign debts that they can no longer service move to a more sustainable situation? Multilateral institutions and governments adopted the Heavily Indebted Poor Countries (HIPC) Initiative, supplemented by the Multilateral Debt Relief Initiative (MDRI), as an approach for the poorest countries. However, they offered only the most general guidance for how the governments of countries that borrow primarily from private foreign sources should resolve a debt crisis. In essence, the international official sector says, "the parties should work it out." And they have, sometimes in an orderly and smooth way, and sometimes not. Numerous authors have proposed policy initiatives to bring more predictability and fairer outcomes into sovereign debt workouts for non-HIPCs (in some cases also aiming to improve on the HIPC process), ranging from sovereign bankruptcy regimes modeled on national corporate bankruptcy systems, to arbitration processes, to standing availability of mediation services (see Kaiser, 2008). Others have proposed informal guidelines or a "code of good conduct" to which debtors and creditors might subscribe as a way to reduce uncertainty about how debt restructuring would proceed. The latter will be the focus of this paper.

While none of the proposed codes has become generally accepted policy, one version of the guidelines approach has come close in the sense that a definitive text, the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets," was drafted in 2004 by an international group of private and official authors. The effort was welcomed (although the text was not explicitly endorsed) by important international official forums in 2004 (the Group of 20) and 2005 (the International Monetary and Financial Committee). Since then, a group of senior financial officials and financial market executives operating under the sponsorship of the private-sector Institute of International Finance have sought to spread its adoption.

Do these Principles solve the problem? That depends on what one sees as the "problem." If the problem is preventing, attenuating or reversing a loss of confidence of private creditors when a government experiences debt servicing difficulties, this author's answer would be, sometimes, but not always. But if the problem is defined as helping a government in debt difficulty return in an equitable way to an economically, socially and politically sustainable debt profile, I would say no, they do not. Moreover, although some parts of the Principles are already accepted in general as good practice (parts that can be classified as "crisis prevention"), prospects overall seem far less certain for the other parts (those pertaining to "crisis resolution"). The latter parts are bound to produce creditor-friendly debt workouts that debtor governments will accept if they feel they have no choice but to quickly normalize access to foreign credit, even if it does little to ameliorate the economic and social consequences of excessive debt servicing. This is a deal that many governments have accepted in the past, although others, such as Argentina, have not.

There are two basic shortcomings with the Principles. One is that they are unbalanced in favor of creditor interests. This could be fixed with some redrafting, but that would still

leave the second flaw, which is that there is no mechanism to push the sovereign debtor and its creditors to abide by them. There is an implicit threat that the private creditors might withhold new loans or agreement on restructuring the debt if the sovereign does not cooperate (one reason the Principles are pro-creditor biased). However, even this assumes a degree of creditor coordination that no longer exists, as evidenced by Argentina's debt restructuring, not to mention the host of private creditor litigation against the poorest countries, aiming to take advantage of the relief accorded by their official creditors (see IDA and IMF, 2007, pp. 24-28). However, it is possible to envisage an official international mechanism that could push the participants toward an orderly, effective and fair debt restructuring. The paper concludes with such a proposal, one that is less than a sovereign bankruptcy regime but more than the hands-off official approach of recent years.

In what follows, we first situate the Principles in the context of international policy developments for treating sovereign debt crises in the late 1990s and early years of the present decade. We then discuss the Principles in some detail and suggest why some of their features are attractive and others are not. This in itself suggests what features of a more balanced set of principles might look like. We also look at how the Principles have been received (without enthusiasm) and see this as an opening for a new approach to the problem. We conclude with the proposal alluded to above.

2. WHY THIS? WHY NOW?

Although proposals for codes of conduct in sovereign debt restructuring have a long history,[3] our story can begin with the financial crises of the 1990s. Beginning with Mexico in 1994, followed by several East Asian countries and the Russian Federation in 1997-98, each crisis was addressed with packages of internationally guided domestic policy adjustments that were complemented by unprecedented volumes of official international financing. The aim of the massive financial rescues was to calm panicked investors and creditors, and restore their confidence in holding assets of the crisis countries. As the countries had previously liberalized their restrictions on international capital account transactions, short-term as well as long-term investors had been freed to move funds in and out of these economies, which they did in large volumes. The result had been a new susceptibility to large swings in financial flows. The vast amounts of international public funds that were deployed were meant to boost investor attitudes so that exchange rates would stabilize and financial markets would quickly resume normal operations.

In the Mexican and Russian cases, the primary debtor had been the government. In the East Asian countries, the private sector was the primary borrower, but the rescue loans for these countries, like those of Mexico and Russia, were all government debt. In the end, each of the crisis countries faced large sovereign debt repayment obligations. Although all the rescue loans were repaid on time with interest, they became officially distasteful to governments of creditor countries by the end of the decade. Policymakers observed that the official bailouts in part covered the withdrawal of private funds from debtor countries in crisis, and that the creditors had succumbed to moral hazard in lending into highly risky situations in the belief — which was largely accurate — that they would be bailed out. Taxpayers in the debtor countries were left to pay the bill.

The new international policy was named "private sector involvement" in debt-crisis resolution (see Group of Seven, 1999, paragraph 44). This odd turn of phrase meant that the governments of the major creditor countries wished that future debt crises of countries with large obligations to private creditors should be resolved less through official financing and more through adjustment of the creditors' claims. This new policy was meant to transfer more of the risk back onto those private lenders. The assumption was that the pre-crisis rush of funds into countries would in the future be tempered by better investor appreciation that significant risks were involved. There should also be higher appreciation that there were risks in lending directly to developing country governments.

However, there was no elaboration of how the creditors' claims would be dealt with when the next crisis erupted, except it was understood that the International Monetary Fund (IMF) could pressure the debtor government and its creditors to work together to solve the

[3] In this author's understanding, only one such initiative led to an international agreement, the so-called "Detailed Features for Future Operations Relating to the Debt Problems of Interested Developing Countries," adopted as an annex to a resolution of the intercessional body of the United Nations Conference on Trade and Development in September, 1980 (TDB resolution 222 (XXI)). Although accepted by developed country governments with the Paris Club mainly in mind, it would be generous to say it was ever fully implemented even there (see Cosío-Pascal, 2008, for additional details).

problem. The pressure could come both from moral suasion and from a policy tool that the Fund had adopted in 1989 to push commercial banks to come to terms more quickly with the debt-crisis governments at that time. That was the policy of "lending into arrears," meaning that the Fund would continue to support a country financially after default and while it accrued arrears on condition that the government actively cooperated with its creditors to negotiate a restructuring of the debt obligations.[4] In 1998 the policy was extended to cover bonds as well as bank loans (see IMF, 2002, pp. 3-7).

Lending into arrears would work to hasten a restructuring by pressuring both sides, but especially the creditors. That is, the IMF announced it would tolerate arrears (which meant it would tolerate default) and use its own funds to ameliorate the economic and social cost of the default. In such an event, countries might more readily suspend payment, after which the market value of their bonds would plunge.[5] Bondholders would thus gain little advantage from delaying agreement on debt restructuring as it would only postpone the recovery in market valuations (whether partial or full) that would come post-workout. There would also be pressure on the government not to delay reaching a settlement owing to the implicit threat that the IMF would remove support if it stopped seeking a workout.

Pressure on bondholders to settle owing to the depressed value of their assets also raised the likelihood of a one-time restructuring with a "haircut," as opposed to dragging out the workout in a series of inadequate short-term refinancing or rescheduling deals, as had been the case with the 1980s bank debt crises and Paris Club treatments (see Garay, 2008 on the former and Cosío-Pascal, 2008 on the latter). This was indeed the intention in the first application of the policy, Ecuador's default in 1999, resolved in 2000 (see Sturzenegger and Zettelmeyer, 2005, pp. 27-29). This meant that private creditors — now primarily bondholders — had to become concerned about how their loans would be handled during a "credit event," something sovereign creditors had not had to think seriously about since the 1980s.

In fact, the IMF had an idea of how to organize the parties to facilitate reaching a debt restructuring that went beyond just pressuring them to do so. That is, in 2001 the IMF management proposed establishing the Sovereign Debt Restructuring Mechanism (SDRM), which would have acted partly like a bankruptcy regime in creating a statutory process for restructuring a government's debt. This threatened to supersede whatever legal mechanisms were embodied in the contractual terms of the loans or bonds and their adjudication in the courts of the creditor countries. The creditors were apoplectic and the governments that relied on selling their bonds to these creditors became fearful of loss of

[4] In fact, the 1989 policy change came after Argentina, Brazil and certain other countries refused to take additional "new money" loans from their banks to stay current on interest obligations; this was in a context as well of growing international concern that the Fund's earlier no-arrears policy had given the banks a veto over the adjustment programs that debt-crisis countries had to negotiate with the IMF (see Buchheit and Lastra, 2007, pp. 5-8).

[5] On the other hand, to the degree that IMF's own lending (before as well as after default) was believed to hasten economic recovery and rebuild debt-servicing capacity, it should raise the market value of the bonds relative to no IMF lending. In this regard, IMF lending functions like debtor-in-possession (DIP) financing of financially distressed corporations, and like DIP financing, creditors accept that IMF has first priority for repayment. While the symmetry is not perfect, Bolton and Skeel (2008) propose creating private DIP financing for sovereigns as part of a more formal sovereign insolvency regime.

access (or more expensive access) to foreign finance. SDRM was killed off in 2003 (for a review of that episode, see Setser, 2008).

Without the SDRM, the question remained open of how best to organize a workout from a government debt crisis when the preponderance of creditors held tradable bonds. The mechanism that had worked in the 1980s to organize hundreds of commercial banks that were already largely tied together through participation in loan syndicates was not directly applicable to the thousands of holders spread around the world of multiple bond issues that were more liquid than the bank loans had been. How should the bondholders be organized most effectively into a group (or groups) that could negotiate with the debtor? How would the decision to accept or reject the government's debt restructuring proposal be arranged?

In part to answer these questions, the international financial sector embraced a proposal to change the contractual terms of the bonds, especially bonds issued under New York law, to make it easier to restructure the timing and/or amount of payment obligations. The intention was to gradually replace old bonds as they matured with new bonds having more appropriate "collective action clauses" (CACs). A committee of central bankers had proposed this back in 1996, in a study that was known as the "Rey Report," after Jean-Jacques Rey, chair of the working party that drafted it (see Group of Ten, 1996). At that time it was promptly forgotten. Now CACs would be promoted as a painless alternative to SDRM. Indeed, they began to be adopted in early 2003 and have since become new "boilerplate" clauses in emerging economy sovereign bond contracts (for the development of CACs, see Gelpern and Gulati, 2008).

While this innovation was deemed to have solved the collective decision problem for bondholders that the IMF had highlighted as the main reason to introduce SDRM, it did not deal with another side of a typical bankruptcy process. That is, under national bankruptcy law, when an insolvent corporation is judged potentially viable after debt reduction, a judicial overseer uses the carrots and sticks in the bankruptcy law to push the debtor and its creditors together toward an "effective" debt workout, usually meaning one that returns as much money to the creditors as a group as is consistent with the debtor having a good chance of emerging from insolvency and operating normally into the future. It is different when a government is insolvent. While the IMF might advise the debtor country on the sustainability of a proposed sovereign debt workout (or, put differently, give its view on how much debt reduction overall is "required"), it has no authority over the bondholders, who are private citizens and corporations, and varying degrees of influence over the government, depending on the state of its relationship at the time with the Fund. Also, despite waivers of sovereign immunity already contained in the boilerplate clauses of bond contracts (which give creditors the ability to bring a defaulting sovereign before the courts in a creditor country), it was widely appreciated that no national authority would help the creditors enforce any judgment the court might make in the creditors' favor.[6]

[6] The earlier "gunboat diplomacy" that was meant to be discouraged by the 1907 Hague "Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts" did not die out until well after the first world war (see Suter and Stamm (1992) on the shifting power of creditors over sovereign debtors in the nineteenth and twentieth centuries).

The financial community responded to this lack of enforceability with proposals to voluntarily organize debtor/creditor relations in good times so as to build up a positive relationship that could be carried forward in bad times in order to cooperatively resolve a nascent debt crisis. The process would arrive at a solution that would perforce be one that the private sector would approve and the debtor would accept. As the approach would emphasize building confidence among the parties before a crisis erupted, it was thought it might help them move more rapidly together to an orderly debt restructuring if one became necessary. The promise of creditor confidence — one could almost say sympathy — even when economic conditions deteriorated severely also held out a possibility of interim private financing, at least rolled over inter-bank and trade credit lines. Whether this kind of voluntary process would also yield an adequate debt workout from the perspective of the long-run development of the country remained to be seen.

An early version of this thinking had been outlined in the Rey Report, the same discussion by central bankers that had contained the CACs proposal, where the authors enumerated policies that they recommended the sovereign debtor, the private creditors and the official international institutions should follow (Group of Ten, 1996). In later variations of the voluntary approach, the recommended policies came to be collected into a proposed "code of good conduct," although in final form they were named the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" (see Table 1).

The terminology change from "code" to "principles" seems important. Principles are less definitive than a code might have been, as they express aspirations for behavior of the relevant players in order to reach specified goals, namely, "stable capital flows and fair debt restructuring." A "code of conduct" would have explicitly proscribed some behaviors and prescribed others. Countries or creditors that subscribed to such a code could be monitored and then criticized (if not also punished) for not following its stipulations. While the "Principles" are less than a code of conduct, they are as close to a code as the selected representatives of different classes of private financial institutions and sovereign debtors could come.

The Principles will not substitute for involving the international public sector in one form or another, just as voluntary, private processes are nowhere deemed sufficient for corporate insolvencies and formal national bankruptcy regimes are deemed essential. We will return to this problem below, but let us first examine the Principles as currently formulated.

Table 1. A Chronology of Proposals to Guide Debtor/Creditor Relations in the Prevention and Resolution of Sovereign Debt Crises	
A	A key committee of developed country central bankers issues the "Rey Report" (see Group of Ten, 1996), which includes a "broad set of desirable principles and features" and singles out aims for each of the main actors in workouts from sovereign debt crises, namely, the international official community, private creditors and the sovereign debtor;
B	IMF extends its "lending into arrears" policy from bank loans to bonds in 1998, and in 1999 introduces the "good faith" criterion to denote an appropriate debtor and private creditor effort to resolve a debt crisis, which is to serve as a condition for IMF to lend to a government although it may be accumulating arrears to its private creditors (see IMF, 1999);
C	The Group of Eight Summit in Cologne in June 1999 adopts the report of its Finance Ministers (see Group of Seven, 1999) on reforming the international financial architecture, including "Improving Crisis Prevention and Management and Involving the Private Sector," which ends overall support for the policy of official bailouts of private creditors of developing countries;
D	The report of a private-creditor oriented working group of the Council on Foreign Relations (2000, pp. 4-6) includes 8 principles for a sovereign debtor and its private creditors to follow in bond restructuring that it suggests could be relevant to IMF's "good faith" judgments; the IMF Executive Board discusses but does not endorse the proposal on January 24, 2001 (see IMF 2001, p. vii);
E	IMF's ministerial level International Monetary and Financial Committee (IMFC) in September 2000 adopts the "Prague Framework" for international crisis prevention and resolution, including "greater private sector involvement," giving additional impetus to rethinking the practices for sovereign debt workouts;
F	The Institute of International Finance (IIF) gives a financial industry response to the Prague Framework with "Principles for Private-Sector Involvement in Crisis Prevention and Resolution," released in January 2001, outlining 9 principles for crisis prevention and cooperative crisis resolution;
G	IMF staff draft a set of "principles and procedures" for debtor/creditor dialogue under the "good faith" criterion (see IMF, 2002); the IMF Executive Board offers largely supportive comments, seeking to balance a need for "clarity" with "flexibility" as regards expectations of sovereign debtors and their creditors and as regards guidance for Fund lending into arrears (IMF, 2002a);
H	The Governor of the Banque de France, Jean-Claude Trichet, circulates "Towards a Code of Good Conduct on Sovereign Debt Re-Negotiation" in January 2003 (see Couillault 2003), suggesting specific "principles" and "best practices" and uniquely introducing the option of a mediator or arbitrator to facilitate the negotiated outcome;
I	The "Gang of 7," a group of private financial sector organizations representing "buy-side," "sell-side" and bond traders, circulate a "Marketable bonds package" containing a draft "Code of Conduct for Emerging Markets" on January 31, 2003, a more creditor-friendly variant of the Trichet proposal;
J	The Group of 20 sets up a working group of four emerging economy member governments to work with the Gang of 7 to prepare a code; the draft "adopted" by a reduced set of the private players and the four countries becomes the "Principles for Stable Capital Flows and Fair Debt Restructuring." The effort is "welcomed" as work in progress by the G-20 in November 2004 and IMFC takes note of it in April 2005. IIF begins to promote its adoption.

3. THE POLICY CONTENT OF THE PRINCIPLES

As noted, although the roots of the Principles may be traced back to official initiatives, their driving force has been in the private financial sector, more specifically the Institute of International Finance (IIF), an organization driven mainly by the major internationally active commercial and investment banks.[7] Not only did IIF lead — one might say, dominate — the effort among private sector organizations to develop the Principles, but it has also taken chief responsibility for marketing them and collecting statements of endorsement from leaders of private and official institutions (see IIF, 2006a). However, while senior officials of 30 debt-issuing countries are reported to have "voiced support" for the Principles (ibid., p. 3), none of their employing governments has formally committed to abide by them, including the four emerging economy countries in the Group of 20 (G-20) that cooperated with the private sector lawyers in drafting the text of the Principles (Brazil, Republic of Korea, Mexico and Turkey); nor have any private financial institutions pledged to follow the Principles. Indeed, they are explicitly non-binding:

> "Because individual cases will invariably involve different circumstances, the *Principles* should be applied flexibly on a case-by-case basis, and are strictly voluntary. Accordingly, no party is legally bound by any of the provisions of these *Principles*, whether as a matter of contract, comity, or otherwise. Moreover, nothing in these *Principles* (or in any party's endorsement thereof) shall be deemed to constitute a waiver of any such party's legal rights." (IIF, 2005, p. 11)

There are four main principles, each of which has two or more sub-principles. If they are followed, they are supposed to "promptly restore market confidence" in emerging market debtors whose policy actions or economic circumstances have begun to worry private creditors and thereby prevent "full-blown crises" from developing (IIF, 2006a, p. 2). The crisis prevention actions called for by the Principles are generally laudable, although somewhat asymmetric, as we will explain. The real difficulties are in the crisis resolution parts. It is not clear that all the creditors or the debtor would want to follow them under conditions of insolvency — and the escape clause in the Principles says they do not have to do so.

3.1. Timely Transparency

The first principle is "transparency and timely flow of information."[8] This is indeed an

[7] As of June 2007, IIF, which is based in Washington, D.C., had over 320 members, about half of which are European financial firms, albeit with "steadily" increasing numbers of emerging market financial institutions joining as well. Its full members include "most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms." It also includes "multinational corporations, trading companies, export credit agencies and multilateral agencies" as associate members (as per information on the IIF web page (http://www.iif.com/about/), accessed June 18, 2007). This said, most members seem to be quite passive and the IIF has primarily reflected the views of the major international commercial and investment ("sell-side") banks.

[8] This and subsequent citations of the text of the Principles are from IIF (2005).

important principle that has been promoted by both the private and official sectors for many years. Financial markets move quickly and may act on rumor and unwarranted investor hunches. The objective here is to "ensure through disclosure of relevant information that creditors are in a position to make informed assessments of [the debtor's] economic and financial situation, including overall levels of indebtedness." As we will see, however, there is an asymmetry in that no parallel effort is made to inform the debtor (or other creditors) of the situations or intentions of each of the different classes of private and official creditors with exposure to the debtor country.

3.1.1. General Disclosure

The Mexican crisis of 1994 provided the inspiration for the principle of government disclosure, as foreign holders of Mexican securities — not to mention official institutions, such as the IMF — discovered they had less timely or complete access to relevant information than desirable and less information than well-connected domestic investors.[9] Following the crisis, the IMF led an international effort, which included wide consultation with the creditor community and national and international statistical authorities, to define guidelines on macroeconomic and financial data dissemination. The outcome was the Special Data Dissemination Standard (SDDS) for countries seeking to raise funds from international financial markets and the General Data Dissemination System (GDDS), which is meant for all IMF member countries and focuses on improving national statistical capacities (see IMF, 2003 and links therein).

There is thus an official international framework on data dissemination. Moreover, once a country "subscribes" to the SDDS, the IMF deems observance of the standard to be mandatory. Also, the Fund (along with other institutions) provides technical assistance to countries seeking to adopt the standards and it monitors implementation as part of its Reviews of Standards and Codes. In this regard and at the general level, the Principles do no more than endorse practices that many countries are already pledged to follow.[10]

This is welcomed, especially as the data at issue are made available to the public and thus all interested stakeholders can access them. In addition, however, requests have been made to increase the transparency of information from other sources. For example, the Argentine finance ministry called for greater transparency of internal reports of multilateral institutions, particularly the IMF, on its assessment of individual developing country debt structures.[11] In fact, the Fund has increasingly made more information available on its debt sustainability analyses in its Article IV consultation reports for the countries that approve release of these reports. The Fund has also modified its standard assessments and sought to

[9] In this regard, it was found that domestic Mexican investors were disproportionately responsible for moving funds out of Mexico as the crisis erupted in 1994 (see Whitt, 1996, p. 15 and references cited therein). Also, IMF acknowledged it did not have sufficient information at hand at the time to appropriately monitor the situation (Fischer, 2001).

[10] IIF has developed standard data templates that go beyond the SDDS, but it has not yet published them (Khalid Sheikh, personal communication, October 2, 2007). If or when it decides to do so, it would be fitting to take the initiative to an appropriate international forum, such as the IMF, for a thorough vetting, revision and international endorsement, as in the original SDDS.

[11] The Argentine comments were prepared in the context of the G-20 discussions of the proposed Principles, in the drafting of which Argentina, a member of the G-20, had not been invited to participate (see Argentina, 2004).

make them more accessible to non-specialist readers (see IMF, 2005). While it is not clear how IMF assessments will be used or how public they will be in a future debt renegotiation, the Principles make no reference to them; they address themselves only to sovereign debtors and their private creditors. Indeed, in this regard the Principles are less compelling than the proposals in the Rey Report of 1996 noted earlier, which addressed recommendations to relevant multilateral institutions as well as private creditors and sovereign debtors.

3.1.2. Specific Disclosure

In addition to the "general disclosure practice" that has been discussed thus far, the Principles call for an additional "specific disclosure practice" that potentially raises certain difficulties. That is, when the debtor's situation requires a debt restructuring, the debtor government is asked to "disclose to all affected creditors maturity and interest rate structures of all external financial sovereign obligations, including the proposed treatment of such obligations." The first part of the "specific disclosure" principle is indeed required, as is a check for consistency between creditor claims and debtor records of its obligations. However, the second part of the disclosure principle seems to embody potential problems, as it could mean asking the debtor to reveal to its private creditors its prospective negotiating strategy with all creditors before a deal is concluded.

The debtor government is asked to tell its private creditors "the central aspects, including assumptions, of its economic policies and programs." Certainly publication of the government's economic policies, "including assumptions," is important to the population of any open society, and it is also essential in any "road show" to explain a proposed bond restructuring to investors.[12]

The question is at what point in the restructuring process the information should be revealed. The Principles seem to ask the government to give privileged information to its private creditors during confidential discussions or negotiations (pre or post default) and before a prospective deal is on the table. Creditors are called upon to ensure "confidentiality of material non-public information." Given the nature of the international financial markets today, it is hard to imagine such information remaining confidential for very long or that some bondholders or some other interested parties would be able to refrain from trading on that information. In addition, as the Argentine finance ministry noted, securities industry authorities that regulate some of the creditor institutions are likely to have their own disclosure requirements that are aimed to provide a level playing field to participants in their market, and thus some creditors would be prohibited from keeping the information confidential. In the Argentine view, "engaging in pre-default consultations with certain private creditors would necessarily entail the transferring of information…and it would generate asymmetric information benefiting certain market participants (Argentina, 2004, p. 3).

There is a simple solution, which is to provide to all stakeholders whatever information is going to be provided to any of them. The Government of Belize applied it in its 2007 debt

[12] Creditors can, of course, choose not to accept a proposed restructuring for countries that do not present such information (appreciation to Shari Spiegel for this point).

restructuring:

> "Belize announced at the outset of its debt restructuring that it would adopt a completely transparent approach to the provision of information to creditors. All analyses of Belize's economic position, its financial prospects and its debt servicing capacity — whether prepared by Belize itself, its financial advisors or the IMF — were posted on a publicly accessible website. Moreover, in what may have been a first in sovereign debt exchanges, Belize also posted on its website several indicative restructuring scenarios showing the extent of the debt relief that the government felt was needed." (Buchheit and Karpinski, 2007, p. 279)

While Belize posted everything, there was no comparable pressure on its creditors to post anything.[13] Creditors are not asked in the Principles to reveal any information about their own situation that might affect their negotiating positions, for example regarding how many creditors of what type had hedged their exposure through credit default swaps. While it might be quite difficult even to collect such information under current reporting arrangements whenever there is a large and fluid universe of bondholders, sometimes the debtor finds it is negotiating with a small number of creditors and the asymmetry of information in the hands of the negotiators could easily be overcome.[14]

A related complaint about creditor opacity was voiced by participants at the 2005 Multi-Stakeholder Consultation on Sovereign Debt for Sustained Development, organized by the United Nations. In that discussion, one group of creditors, the national export credit agencies (primarily of developed countries), was called upon to be more forthcoming in providing information about their intentions as regards countries that enter into debt difficulties. As it is, "non-disclosure policies generally make it very difficult to understand [export credit agencies'] decision-making processes," according to the report of the dialogue (see United Nations, 2005a, p. 8).

In conclusion, one may wonder to what extent the selectivity in who receives government information in times of financial stress, the constraints on keeping such information confidential, and the asymmetry between the information to be provided by a government and by its creditors would deter governments from engaging in fully cooperative pre-crisis consultations, which is a stated central aim of the Principles. Indeed, regardless of senior management praise heaped on the Principles beforehand, would it not be incumbent on international banks without a permanent presence in the country to protect their shareholders by withdrawing funds from the country once they received confidential

[13] Creditors that are publicly held corporations might have to report certain information on their net exposure to troubled debtors in their quarterly reports to shareholders (thus with a lag), and some financial institutions might have to report details to their regulators (although the latter information would be deemed confidential). Also, some aggregate creditor information — albeit on a national rather than sovereign basis — is posted quarterly in the reports of the Joint External Debt Hub that is maintained by the IMF, the World Bank, the Bank for International Settlements, and the Organization for Economic Cooperation and Development (see http://www.jedh.org).

[14] In an extreme case, that of Moldova, after a buy-back operation, only a single bondholder remained with whom Moldova negotiated its debt restructuring (see Shari Spiegel, "Lessons from Moldova on How Not to Borrow," unpublished manuscript, 2006).

information that a crisis was worsening? The creditors face no prospective penalties for being misleading or uncooperative in their consultations with the government. For them, it is a purely voluntary system. In other words, the absence of any obligation on any creditor to abide by the Principles, as noted above, might weaken a sovereign's willingness to trust its creditor partners as it slid towards a financial crisis.

3.2. Debtor-Creditor Dialogue

The second Principle takes us into the form and content of "debtor-creditor dialogue and cooperation to avoid restructuring." It has five sub-principles, but they actually amount to one: close dialogue in good times or bad. Dialogue in good times has been welcomed both in principle and practice. However, the expectation for what dialogue can accomplish during difficult times, e.g., in the face of a looming debt crisis, seem rather optimistic. It appears to hinge on the country being solvent, in which case the creditors would not need to take a haircut. As this is very hard to know in the midst of a crisis, the outcome of such consultations might be relatively more favorable to the creditors, who act on the presumption of solvency, than to the possibly insolvent debtor. We consider the two dialogues in turn.

3.2.1. Dialogue in Good Times

Dialogue in good times comprises sub-principles called "regular dialogue" and "best practices for investor relations," plus a third sub-principle on country policy. The core proposal is to establish a formal mechanism through which a debtor government would routinely communicate with its creditors. Denoted an "investor relations program" (IRP), it would ideally be an identifiable government unit housed in either the central bank or ministry of finance. Activities of such a program would include "disseminating accurate and timely data/information through e-mail or investor relations websites; establishing formal channels of communication between policymakers and investors through bilateral meetings, investor teleconferences and videoconferences; and maintaining a comprehensive list of contact information for relevant market participants." Creditors would be encouraged to use the IRP and "provide feedback on such information and data."

The IIF has been promoting IRPs for almost a decade, and the IMF has encouraged them as well (see IMF, 2004). The major emerging market borrowers that have overcome crises or periods of investor unease have especially felt the need to introduce IRPs to build investor confidence. Nevertheless, as of September 2006, only 10 of the 30 most active emerging market borrowers had established formal IRP offices (Brazil has two!).[15] Other countries provide varying degrees of cooperation with creditors in the spirit of IRPs. One possible reason for not adopting full IRPs is cost. At least, representatives of some governments of small, middle-income economies, which did not envisage significant borrowing, "did not seem to put a high priority on spending significant amounts of financial resources on investor relations" (United Nations, 2005, p. 11). There are economies of scale in the effort, as for example in developing and maintaining a web site. It is a different matter if the intended audience is a few thousand or a few hundred

[15] The 10 are Brazil, Chile, Hungary, Indonesia, Republic of Korea, Morocco, Peru, Philippines, South Africa and Turkey (IIF, 2006b).

thousand. Regional cooperation might be a way to spread the costs, but it does not seem there has been any activity in this regard. Also, there has been only limited take up of an independent initiative to provide an information and communication web portal that would collect and disseminate investor-relevant information and provide a channel for two-way investor/government communication.[16]

The major advantage of IRPs is to provide outreach to external investors who might find it difficult to stay fully informed about domestic developments in the borrowing country. Indeed, the IRP should provide a "public good" for the external investors as a group, opening up what would otherwise be individual private conversations of the government with its largest creditors, who send interlocutors to the debtor country to gather information for their clients (Herman, 2003, p. 206). The IRP also provides a means for investors to report back to the government their assessment of the information provided, which allows for a critique of the quality and timeliness of the information made available and thus pressure for their improvement. As long as the information made available through the IRP is also made available to the public at large — and no efforts are made to suppress information — the IRP would be providing a public service to all citizens of the country and should be applauded.

There is a potential negative side of this dialogue issue, however, highlighted by the third sub-principle, called "policy action and feedback." In this, debtor governments are called upon to implement "economic and financial policies, including structural measures, so as to ensure macroeconomic stability, [and] promote sustainable economic growth." The problem is that there is often disagreement over which policies are best suited to achieve these laudable goals. The text of the principle continues that "political support for *these* measures" should be developed [emphasis added], and that governments "should closely monitor the effectiveness of policies, strengthen them as necessary, and seek investor feedback as warranted."

Government officials may take their advisors from wherever they please, including the foreign investor community. The difficulty comes if advice turns into pressure. In this case, consider that the goal of the investor in sovereign risk bonds is first and foremost to maintain the value of their securities, and the probability of being repaid. This provides only a limited overlap with the much broader goals of the government. For example, one may expect investors to be aware of the threat to political sustainability if a government squeezes the population excessively to maintain uninterrupted debt servicing.[17] Yet there is a wide range of policies that enable governments to repay their debt and are politically sustained but are not necessarily best for the people of the country or the development of the economy (see Stiglitz et al., 2006). In any case, this is a matter for the domestic political process and not the foreign creditors to decide. In sum, if the views of foreign investors expressed through the IRP are simply added to the public policy discussion in a

[16] The initiative, supported at various times by foundations and donor governments, plus considerable "sweat equity" of its founder, Barbara Samuels II, is the Global Clearinghouse (see http://www.globalclearinghouse.org).

[17] Nevertheless, the treatment of Indonesia in the 1997-98 crisis suggests that sometimes neither creditors, partner governments nor multilateral institutions adequately perceive the debtor government's tipping point (assuming the destabilization of Indonesia was unintentional).

country, it seems that little harm would be done and possibly some good. One should not seek anything more.

3.2.2. Dialogue in Troubled Times

The strategy embodied in the principle of dialogue while conditions worsen is to avoid default, which would trigger complicated processes of negotiation (see next section). The two sub-principles that directly address this strategy are called "consultations" and "creditors' support of debtor reform efforts." The goal is to maintain continuous market access by building investor confidence and avoiding "misunderstanding about policy directions," a nice turn of phrase to suggest the debtor government might want to think hard before disregarding the private financial sector's policy prescriptions. As already noted, the private creditors and their shareholders do not have the same interests as public policy makers. The mandate of the private institutions is to protect creditor interests, both in terms of their own exposure to the country and more broadly in light of possible contagion that might disrupt the international market and their other exposures.

Governments may or may not want to follow the creditors' advice, but the Principles not only threaten them but also offer two financial "carrots" to do so. The first carrot is contained in the call on debtor governments to "consult with creditors to explore alternative market-based approaches to address debt-service problems before default occurs."[18] In other words, the creditors may offer the prospect of "re-profiling" repayment obligations through a voluntary swap of old bonds for new ones with later repayments. For this to work, the leading international investment banks and other participants in the dialogue would need to encourage existing bondholders to join the swap, expressing confidence in the soundness of the policies being followed and the view that the country was having a liquidity problem and not an insolvency crisis.

One should be clear, however, on what is being offered. The voluntary swap-as-solution depends on the assumption that a decline in market confidence that makes the swap necessary is not actually warranted and that a concerted creditor effort would help avoid an unnecessary default. For example, if a bulge in payments was falling due and if market confidence in the country were high enough, the government would be able to raise the funds in the normal way (at normal interest rates) to handle its debt-servicing bulge. But once confidence has slipped, a collective creditor approach would need to be substituted in a special — albeit voluntary and market-based — arrangement. The new bonds would presumably have to carry an interest rate that reflected creditor concerns about their recovery value and the swap into the new bonds would also presumably earn significant fee income for the investment banks arranging it. In fact, cases often cited as examples of cooperative debt swaps in the sense promised by the Principles, such as Uruguay in 2003 and the Dominican Republic in 2005, have proved quite good deals for the creditors (see Spiegel, 2008), while it is less clear they have addressed the countries' debt sustainability and development needs.

The second financial "carrot" is an offer to help keep sovereign debt concerns from

[18] The consultations are meant to be at a general policy level and not treat specific financial transactions that might be of interest to individual private sector interlocutors.

mushrooming into a wholesale domestic financial crisis. In this case, the offer is that "the creditor community should consider, to the extent consistent with their business objectives and legal obligations, appropriate requests for the voluntary, temporary maintenance of trade and inter-bank advances and/or the rollover of short-term maturities on public and private sector obligations...." This offer would apply not to thousands of dispersed bond investors but a limited number of international commercial banks.

Most of the credits and credit lines that would be kept open are made by private lenders to private borrowers, mostly banks, although there are instances in which foreign banks lend short term to the government or under government-guarantee. In many cases, foreign banks would not cut their short-term credit lines to local banks as a consequence of a sovereign debt crisis per se. However, they might do so if the local banks held large amounts of sovereign debt whose viability had been put into question, which is not uncommon. Foreign banks might also come to worry if the sovereign debt crisis embodied a loss of confidence in the overall economy, capital flight and a run-down of foreign exchange reserves, i.e., a broader financial and balance-of-payments crisis (as in the 1990s Mexican and Russian cases). Whatever might be scaring the suppliers of foreign short-term credit lines, pulling them would assuredly be devastating for the economy and thus for the debt-servicing capacity of the government. None of this would be good for the recovery value of the medium-term government debt.

In this regard, the offer in the Principles to maintain the lines while the government undertakes confidence-building measures may be understood as in the interest of the creditors as well as the government. It also gives the creditors a weapon, as they could threaten to withdraw the credit lines and punish the people and the economy if the government were not sufficiently sympathetic to the creditors' views on the preferred macroeconomic policies or the terms of a re-profiling bond swap. But while all the creditors might benefit from this stance, bondholders as well as other creditors, only banks are potentially promising to maintain credit lines and they can only be assumed to act in their own interest. Indeed, even if the banks made a convincing case that they could be relied upon to promote the public interest in the debt-crisis country, let alone the broad creditor interest, the history of international commercial bank finance during crises does not inspire confidence that they would do so. As we have observed before, banks are not governments. Those commercial banks with physical presence in the domestic financial sector may well find it expedient to maintain their short-term credit lines, whether or not the government follows the bankers' preferred policy options. Others would not. As a general proposition, the debtor government should probably take less comfort from the carefully circumscribed promise in the Principles to maintain credit lines than from the strong pressure that might be put on those banks to do so by their home governments if the debtor government is cooperating with the IMF.[19]

[19] The case of the Republic of Korea at the beginning of 1998 is instructive. Korea's problem debts were not government obligations, but it took government actions to resolve the problem. The foreign debt of Korea's banks and the central bank's shortage of foreign exchange created an emergency situation at the end of 1997. IMF provided emergency liquidity to a newly elected government committed to a rigorous adjustment program, but private foreign banks refused to roll over maturing short-term loans to Korean banks. Strong political pressure by the home governments of the private banks and Korean government guarantee of loan

Indeed, it is curious that the IMF is omitted from the cooperative dialogue discussion in the Principles. Linking financial support to policy change is what the IMF does under an international mandate. In other words, one may see the Principles as offering a private version of an IMF policy dialogue and Stand-by Arrangement with the government, albeit with less promise of new financial resources than the IMF sometimes puts on the table.

It is understandable that the creditors might want to supplant the IMF, especially after the Fund began its "private sector involvement" policy and became a less reliable friend of creditor interests. As market commentators were fond of saying at the time, the Fund is a "political institution." Indeed, it is hard to believe the Fund is any less susceptible to political pressures under the new policy than when it defended private creditor interests more assiduously.

For all the criticisms made of the IMF — which have been louder and longer from those speaking in the name of the poor who are most hurt during adjustment programs than from the creditors — it is a little surprising to think the government might prefer to work directly with its private creditors instead of the Fund. Perhaps the authors of the Principles thought that the government might want to discuss its adjustment needs with its creditors before discussing them with the Fund. Creditor representatives would be available for such discussion, as there is meant to be continuous dialogue between the private creditors and the government through the IRP. In any event, one should expect the creditors to defer to any adjustment program that the government might develop in a policy dialogue with the Fund staff, especially after it was endorsed by the Fund's Executive Board. It is perhaps an oversight, but the Principles are silent on the relationship of the creditor dialogue and that with IMF, let alone with intergovernmental alternatives to the IMF that might emerge from recent bilateral or regional initiatives, as in East Asia and South America.

3.3. Good Faith Debt Renegotiation

The policy dialogue and private financial cooperation discussed above is viewed as taking place before the government defaults on any of its obligations to creditors. Those cases presume the problem is one of illiquidity, not insolvency; i.e., that the government would be able to meet its obligations over the long run if it could only get over the temporary loss of confidence and return to normal access to credit. The third Principle addresses outright debt renegotiation, and thus cases that are more likely to reflect insolvency. In these cases, whether or not the government actually defaults, its payment obligations have become unsustainable and a debt restructuring process has to be set in motion.

The Principle to handle this situation is called "good faith actions," and the phrase "good faith" is not accidental. As noted earlier, that is how the IMF names the criterion it uses to

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repayments brought a temporary roll over in January 1998, giving time to negotiate a medium-term rescheduling of the debt in March 1998. With additional IMF funding and a Korean sovereign bond issue in April 1998 to further bolster reserves, the crisis ended. The point here is that international commercial banks were unreliable partners in the Korean adjustment until forced by their governments to act "responsibly" (see Lee and Orr, 1999, pp. 97-100; on the coordinated government pressure on the banks, see Berensmann, 2003, pp. 33-34).

denote acceptable debtor government and creditor cooperation to resolve a debt crisis.[20] The good-faith negotiations Principle contains five sub-principles which together describe how a debt restructuring negotiation should be undertaken. They may be separated into policy aims and actions that the debtor and its creditors should embrace, and how the negotiations should be carried out.

3.3.1. Policy Aims and Actions

The underlying thesis is that the debtor and its creditors can and should cooperate in seeking an effective debt workout, i.e., that they should adopt a "voluntary, good faith process," which is the name of the first sub-principle. Under such a cooperative process, the government would adopt "sound policies" that seek "to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance-of-payments sustainability in the medium term." The debtor and its creditors should identify "the best means for placing the country on a sustainable balance-of-payments path, while also preserving and protecting asset values during the restructuring process" (the "asset values" are, of course, the creditors' assets, which is to say the debtor's liabilities).

However, as the Argentine finance ministry reminds us, there may be an inconsistency between "protecting asset values during the restructuring process" and "viable macroeconomic growth and balance-of-payments sustainability in the medium term." As they emphasize, "There can be no good faith negotiations if the final result is not a sustainable debt structure," i.e., Argentina includes in its definition of "good faith" that the aim of the restructuring should be to leave the country with significant growth — and thus debt-servicing — prospects (Argentina, 2004, p. 5). In the Rey Report in 1996, the central bankers listed among their 11 recommended principles and features of a sovereign workout process that it "should support credible and sustainable actions and, to this end, not impose excessive social, political, or economic costs on the debtor" (Group of Ten, 1996, p. 2).[21] Unfortunately, this was not included in the Principles.

A related set of sub-principles speaks to debt servicing during the restructuring process. The primary concern expressed is that creditors be paid: "Debtors should resume, to the extent feasible, partial debt service as a sign of good faith and resume full payment of principal and interest as conditions allow." There is no acknowledgement, however, that the government might need to weigh signaling "good faith" to its creditors versus to its own population, whose essential public services would likely have been cut back by the crisis. Governments are also expected to make sure that trade lines are fully serviced during the restructuring period, a point discussed earlier; i.e., sufficient foreign exchange should be made available to the banking system for this purpose. As also noted earlier, the

[20] The Principles' text on "good faith" requests that the IMF "implement fully" its good faith policy, bringing us 180 degrees from the original IMF concern. In other words, the Principles here call on the IMF to push the debtor government to negotiate with its creditors, whereas the original concern motivating the IMF policy of lending into arrears was that Fund programs not be held hostage to the inability or unwillingness of private creditors to come to a conclusion in their negotiations (see IMF, 1999, pp. 4-6). We return to this matter in the concluding section.

[21] A similar sentiment was embodied in the aforementioned UNCTAD "Detailed Features…" of 1980, which called for "safeguarding [the crisis country's] development process" and comparing estimated short and long-term investment and debt servicing requirements with projected resource availabilities (paragraph 7).

economic cost of the withdrawal of trade credit lines makes this essential, so this much is likely a priority already shared by the government.

Further under the heading of actions during restructuring, the Principles say that governments "should avoid additional exchange controls on outflows, except for temporary periods in exceptional circumstances." The exceptional circumstances qualification is a welcome vindication of the Malaysian policy during its 1990s crisis, one that the IMF now shares (see IMF 2005a, p. 46). Indeed, it is increasingly appreciated that open capital markets lead to excessive volatility without adding to growth, and recent research suggests that capital account regulation can be a useful tool in macroeconomic policy (e.g., see Stiglitz et al., 2006). One may thus ask whose interest is being protected by generally discouraging exchange controls, in particular on short-term flows. It seems less an imperative for medium-term creditors than for the international banking and securities trading industries.[22] Indeed, even after investor panic subsides, exchange controls might help shelter the government's access to foreign exchange from renewed speculative outflows and thus advance resumption of the servicing of the bonds and other long-term sovereign loans that the Principles emphasize. The question of whether to maintain controls or not, to set them on inflows or outflows, rely on administrative restrictions or financial deterrents, all seem best determined after the country is assuredly on its path to recovery.

The final category of policy aims discussed under the Principle of good faith action is labeled "sanctity of contracts." The word "sanctity" is certainly evocative, as it derives from the Latin word for holy. Aside from saintliness or purity, the dictionary will tell you the word also carries meanings of sacredness, inviolability and binding force. Here the focus is entirely on creditor rights to repayment that are embodied in the covenants of bond contracts (or bank loans). "Sanctity" is asserted "to ensure the integrity of the negotiating and restructuring process," which is to say it aims to maintain creditor belief that their claims will be protected to the maximum extent possible even in the face of insolvency. The Principles are very clear: "contractual rights must remain fully enforceable." This is a point on which creditors would insist and that governments wanting continued access to private finance could not do otherwise than acknowledge in signing a bond contract.

The rights at issue here include the ability of individual creditors to take the debtor to court and seek enforcement of repayment terms (although bonds issued under the new CACs introduce some constraints on individual bondholder rights). However, while sovereign debtors need to be careful what commercial assets they leave exposed to capture by disaffected foreign creditors, it does not mean that gunboats will be dispatched to collect for those creditors that decide not to participate in a debt workout arrangement. Creditor rights may be sanctified, but that does not mean they trump all other rights or that they are enforceable against a sovereign.

In the face of a looming insolvency, the authors of the Principles remember the IMF and

[22] While unrestricted capital flows may be a long-term goal, it can be recalled that exchange controls on short-term flows seem to have advanced the confidence of long-term investors, and may be one reason flows of project finance — not to mention foreign direct investment — continued unabated to China and India all through the Asian financial crisis.

seek its help to "support the debtor's reasonable efforts to avoid default." Indeed, the word "reasonable" is essential here. One can posit ethical reasons — ones that a "reasonable" person might find compelling — to override contract "sanctity" and unilaterally suspend payment (see Herman, 2007). Any judge hearing a creditor complaint against a developing country government that defaults could well do with some explicit international guidance as to when it might be deemed justified. The Principles do not help us here.

In sum, the propositions asserted by the Principles on debt renegotiation policy represent the private creditors' perspective. But sovereign debt workouts also have social and economic imperatives. The sovereign *should* seek sufficient overall relief to return to adequate growth of per capita income, employment, poverty reduction and financial sustainability and do so sooner rather than later. In the past, the IMF has had a lead role in setting the overall financing "envelope" that it deemed warranted by the country's situation, within which some split between debt relief and "new money" would need to be negotiated among the relevant parties. One can argue whether or not the IMF systematically underestimated how much net financing would be needed in past debt-crises, but one can hope that in the future a reformed international monetary organization, governed differently than IMF is today, would set the envelope adequately so that governments in need would be attracted to cooperate with the Fund and not come only out of desperation. How much "violence" is then done to sovereign debt contracts with private creditors will depend on where that overall financing envelope is set, how it gets divided between new funds and debt relief, and how well the different classes of creditors are able to advance their claims within that process. In this regard, a comprehensive or coherence-ensuring sovereign debt restructuring approach is important. This author cannot find it in the Principles.

3.3.2. Arranging the Negotiations

According to the Principles, while "the appropriate format and role of negotiation vehicles…should be determined flexibly and on a case-by-case basis," the first negotiation sub-principle is about forming "creditor committees." If a group of creditors should start to form such a committee, the Principles say that "both creditors and the debtor should cooperate in its establishment." As has been the case since the nineteenth century, large financial firms representing the major creditors of a debt crisis country could come together to deal with a country's defaulted debt. In the Argentine case, however, committees of small creditors also formed (e.g., German small-scale bondholders[23]). These were obviously not the primary creditor interlocutors of Argentina — however, neither was the committee of large bondholders (see Porzecanski, 2005, pp. 323-326). One should not assume, in other words, that a creditor committee will easily be formed to represent the wide range of different bondholders, often with disparate goals. Indeed, it has not been the usual way in the recent decade or so of bond debt restructuring cases. Nevertheless, it is the preferred option in the Principles.

If the private creditors of a distressed sovereign do form themselves into a single creditor committee, they would have to sort out among themselves who would serve as the principal leaders and actual participants in the envisaged negotiations. To the degree that

[23] Notably, the *Interessengemeinschaft Argentinien e.V.*, headed by Stefan Engelsberger.

major creditors from different communities had already been brought together under an IRP during "good times," there could be a nascent network of individuals from among which the creditors' committee could be formed. Moreover, CACs for individual bond issues would specify how the interests of those bondholders should be represented and the appointed agent would presumably serve on the creditor committee.

In fact, representativeness has been a concern in recent efforts to form such committees. In some cases, IIF reports, legal advisors of debtor governments have requested that proposed members of creditor committees secure proof that they actually represent other creditors. Requesting such proof could be a useful tactic if the government did not want a particular individual to sit across the table at the negotiations. However, except for a small number of cases in which a group of fund managers and other creditors have appointed a representative to act on their behalf (and in future when formal agents could be chosen to restructure bonds under CACs), committee members apparently do not "represent" other creditors but reflect "the views of the creditor community during the negotiations with a view toward attracting a critical mass of support for negotiated restructuring terms" (IIF 2007, p. 12 and IIF, 2006, [no page number]). The difficult question for a world with highly dispersed holders of the bonds of major debtor countries is whether self-appointed committee members would in fact be accepted by a working majority of creditors as adequately reflecting their interests.[24] Indeed, in its recently issued "Best Practices for Formation and Operation of Creditor Committees," the IIF Principles Consultative Group (see below) acknowledges that the "committee must have credibility with the debtor and be able to signal that it has influence with a critical mass of all creditors and investors" (IIF, 2007, p. 13).

The Principles envisage that the creditor committee would function much like the "London Clubs" that negotiated restructurings of international commercial bank debt in the 1980s. That is, the creditor committee should be "a forum for the debtor to present its economic program and financing proposals; collect and analyze economic data; gather, evaluate, and disseminate creditor input on financing proposals; and generally act as a communication link between the debtor and the creditor community." The committee is also expected to "coordinate across affected instruments and with other affected creditor classes, with a view to form a single committee."

There are reasons to think, however, that this last expectation would be difficult to arrange. The institutional differences between banks and bondholders suggest that each group might prefer to talk separately with the government. Indeed, it is still typical for bank credits to be renegotiated in "London clubs" and bonds to be addressed by government bond exchange offers. But it can easily get much more complicated. In the 2005-6 Iraqi debt restructuring, separate creditor committees formed for "commercial banks, trade suppliers, North African trade suppliers, Asian construction companies, and so forth" (Buchheit and Karpinski, 2007, p. 279).

[24] Not every bondholder would have to accept the committee's legitimacy, but a large enough share of bondholders would have to feel their interests were adequately represented so the committee's proposal could win a restructuring vote (as under the CACs) or effectively "cram down" the new arrangement over the objections of a recalcitrant minority of bondholders, as through votes by an effective majority to negatively modify old bonds as investors swapped into new ones ("exit consents").

Certainly, one may doubt that the "single committee" would include the bilateral official creditors that usually work through the Paris Club (unless the Club led it). The SDRM experience, noted earlier, is especially discouraging on this score.[25] Members of the Paris Club have bound themselves into elaborate and specific rules for treating problem debt and would be extremely reluctant to instead join another process that works on different principles (see Cosío-Pascal, 2008).

Whatever the scope of the creditor committee, to be able to operate it has to address certain difficulties, including resolving a point noted in the transparency discussion above concerning "material non-public information." While the Principles contain no elaboration on this point, the IMF considered it in its 2002 paper on "good faith" actions (IMF, 2002, p. 14). The IMF observed that a negotiation necessarily entails offers and counter-offers and it is of their essence that they be held confidential during the negotiation process. The Fund noted that the temptation for a creditor to trade on the information would be very high and so proposed that not bondholders but professional advisors sworn to maintain confidentiality should negotiate on behalf of the bondholders.[26] The Fund also proposed that in a complex restructuring the debtor and the committee might jointly appoint a mediator to facilitate the negotiations (ibid., p. 12). While that proposal has also been made by private sector, civil society and official authors, the Principles are silent on whether it should be encouraged or even considered potentially useful.[27]

A further challenge that a creditor committee has to meet if it is to negotiate on behalf of all its members is to forge a single, common negotiating strategy. This means it would have to find the common ground among diverse interests, as between original "buy and hold" bondholders, bondholders that maintain a portfolio of emerging market bonds but regularly "churn", repackage, or hedge them and modify their effective exposure (e.g., strip them into parts with different risk characteristics, offsetting some of the parts with credit default and other derivatives), and speculative investors who buy distressed bonds at a small fraction of face value to profit on the rise in price following the debt workout.

Owing to how difficult this is in practice, one may envisage the bondholders' committee

[25] That is, IMF staff had proposed including governments as one of the classes of creditors under the SDRM. Private creditors saw the value of this approach, but the official creditors would have none of it (see Hagan, 2005, pp. 352-354).

[26] The IIF "Best Practices" for creditor committees noted earlier comes to essentially the same conclusion: "In order to facilitate participation by hedge funds and asset managers who may face conflicts of interest when they come into contact with material non-public information…, an external representative could be appointed… (IIF, 2007, p. 13).

[27] One additional concern in the Principles might be mentioned here, namely, that the debtor should pay the "reasonable costs of a single creditor committee" and that the creditors and debtor should jointly decide what constitutes reasonable costs. This was the practice in the 1980s bank debt restructurings and is the corporate practice as well. It is probably inevitable that the debtor formally covers this charge, both for reasons of precedence and as otherwise many creditors might refuse to be represented by the creditor committee and seek individual redress in the courts. Politically, it may pose certain difficulties for the government; however, the charges are fungible and could be factored into the final terms of the "haircut." Curiously, especially as this was a contentious matter in the inter-creditor negotiations of the text of the Principles, there is no mention of sharing the committee's operating costs with the debtor in the new "Best Practices" for creditor committees. Instead, creditor committee members are called on to share responsibilities among themselves for providing facilities and staff, and for handling communications (IIF, 2007, p. 14).

meeting with the government not for negotiation but consultation. Discussions would not need to take the form of offer and counter offer. The government could instead try to judge from an informal dialogue what kind of bond exchange offer would likely attract sufficient participation to make the swap a success. In fact, this is how it has been done. The government meets with various bondholder groups (if there is more than one committee) and/or major bondholders prior to making a formal offering to swap old bonds for new ones with terms believed to be acceptable to the bondholders. When creditors are happy with the outcome, they call it a case of "debtor-creditor cooperation," as in the Dominican Republic (IIF, 2006, no page numbers). When they are not happy with the outcome, they call it "uncooperative" and a "unilateral exchange offer," as in Argentina (Porzecanski, 2005, p. 323).

This is not to say that single creditor committees are always impractical. The IIF cites the handling of the debt difficulties of Grenada in 2005 as a case of a creditor committee that functioned successfully (IIF, 2006, box 1). Grenada needed relief because in 2004 Hurricane Ivan devastated the island, destroying or severely damaging nearly 90 percent of its housing stock (Buchheit and Karpinski, 2006, p. 227). Perhaps this sudden catastrophe plus the fact that Grenada had been well regarded in international markets up until the hurricane help explain the willingness of creditors in this case to expeditiously work through a creditor committee. Grenada is also a small debtor: the hurricane had forced it to miss interest payments on two international issues that were held by a limited number of bondholders but comprised the bulk of its external commercial debt of less than $178 million.

Moreover, despite an unprecedented effort of the government of another small country, Belize, to encourage formation of such a committee a year later, one "did not coalesce" and the government instead had to consult with its creditors "individually and in groups" (Buchheit and Karpinski, 2007, p. 279). While having a committee would have had certain advantages, not having one did not seem to impede the restructuring, which was accepted by 98.1 percent of bondholders (ibid.). But again, this was a relatively simple case, with a small number of securities to restructure.

The potential advantage of a creditor committee seems far more compelling for big debt crisis cases, albeit more difficult to organize given that it has to be done on a purely voluntary basis under current arrangements. Rather, some means to push the different classes of creditors into workable groups for discussion, if not negotiation, seems a practical necessity. The weakness of the Principles is that as a voluntary mechanism it lacks a way to bring this about. It does not substitute for the "carrots and sticks" of a bankruptcy regime.

3.4. Fair Treatment (of Creditors)

The last main Principle involves a relatively short text that calls for "fair treatment," although the only concerns expressed are that creditors be treated fairly. Indeed, the first sub-principle is a call to avoid "unfair discrimination among affected creditors." This begs the question of what is unfair discrimination.

There is a delicate point in this, which is that formally, there is no specified priority for repayment in sovereign risk lending, although the informal convention is to accord first priority to the IMF and the multilateral banks. Moreover, the government creditors that cooperate through the Paris Club generally demand and receive preferential treatment over private creditors in debt restructuring in the sense that the governments usually do not accept to take any "haircut" in restructuring their claims on a middle-income country.[28] Paris Club creditors also routinely demand "comparable treatment" by private creditors to their own offer of relief, by which they really mean that private creditors should receive no better treatment from the debtor than the official creditors. "Worse treatment" — deeper debt relief — is perfectly acceptable. In addition, sovereign governments may choose to actually treat different classes of private creditors differently, depending on their national economic and financial needs (see Gelpern, 2004). Argentina, for example, defaulted on its bonds and certain other liabilities, but not on the "guaranteed loans" issued just before the default, many of which were held by domestic pension funds and insurance companies (see Damill et al., 2006). Given the economic shock of the crisis to the financial system, as already noted, this was understandable.

The Argentine finance ministry raised an additional challenging point regarding "fair treatment" of creditors. In this view, the Principles missed an opportunity made salient by the thousands of European households, especially in Germany and Italy, who claimed they were misled by "certain placing institutions" that sold them financial instruments that were "unsuitable" for them and whose risks they did not understand (Argentina, 2004, p. 6). As the ministry stated, "It is not equitable to treat equally unsophisticated retail investors and large institutional investors." Besides giving preferential treatment to the household investors, they also suggested giving preferential treatment to "original" purchasers, "the ones that purchased the debt instruments at face value." Lastly, they suggested giving "differential and less preferred treatment to those bondholders who purchased their securities after open default situations" (ibid., p. 11). One may imagine different views on Wall Street, especially from the "bottom fishers," who would argue that they're being compensated for providing liquidity when no one else is willing to do so. However one judges the ethics of that claim, it certainly raises the issue of fairness as it might have been explicitly considered in a set of principles.

Finally, if the authors had wanted to make the Principles more balanced, they might have added another point to this section. That is, the Principles could have called for creditor restraint in seeking redress through the courts while a cooperative debt workout process was underway. This is already part of the IMF "good faith" criterion as considered by the Fund's Executive Directors in 2002. Their expectation at that time was that when a "formal negotiating framework" (e.g., a creditor committee) is utilized, then good faith negotiations would include, inter alia, "the agreement to a standstill on litigation during the restructuring process by creditors represented in the committee" (IMF, 2002a).[29] This

[28] Only very low-income countries (HIPCs) or politically important cases or unusual cases under what is called the Evian Approach would potentially qualify for any of the non-standard terms (see Cosío-Pascal, 2008).

[29] The complication here is that many individual bondholders that are perforce "represented" by virtue of being in the group of defaulted creditors might not quietly agree to be led by the committee, but instead exit

would have been somewhat comparable to a "standstill" in a corporate bankruptcy process. However, in the Principles it would have been a moral pledge not a court ordered requirement; indeed, it would have been a pledge on which no one endorsing the Principles could have been held to account given the disclaimer with which the Principles began. Even so, this point was apparently too controversial for a private-sector led initiative.

by dumping their bonds at whatever price or seek individual redress in the courts, as was the experience with the ineffective Global Committee of Argentine Bondholders (see Gelpern, 2005).

4. LUKEWARM RECEPTION AND FOLLOW UP

Once the Principles were released, it became clear they represented a consensus among only a limited range of players. The proponents of the Principles in the international financial industry have been trying, nevertheless, to spread their acceptance to other parts of the industry and to governments, if with limited success.

4.1. The Official and Private Sector Reception

In the international official sector, the Principles were welcomed, but only as a work in progress. The G-20 finance ministers and central bank governors, meeting in Berlin under the chairmanship of Germany, included the following in their communiqué of November 21, 2004:

> "…we welcomed the *results achieved* between issuing countries and private-sector participants on 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.' Such principles, which we *generally* support, provide a *good basis* for strengthening crisis prevention and enhancing predictability of crisis management now, *and as they further develop* in future" (paragraph 8, emphasis added).

One may read this as a warm statement of appreciation for the private-sector leadership of IIF (whose chair, Josef Ackermann, was also the chair of Deutsche Bank), and encouragement to keep working. Perhaps a crisper reflection of government views on the Principles was given by the International Monetary and Financial Committee (IMFC) of the IMF, also at the level of finance ministers and central bank governors, but representing global constituencies, which took note of the Principles (a weak degree of endorsement) at its meeting in Washington, D.C. on April 24, 2005:

> "[IMFC] notes the 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets' being developed by a number of sovereign issuers and the investor community, and *encourages further efforts to improve the Principles aimed at achieving a broad consensus*" (paragraph 17, emphasis added).

The next annual meeting of the G-20 ministers took place in Beijing on October 16, 2005. That meeting's communiqué was somewhat less enthusiastic than its previous statement in 2004 had been:

> "We welcome the efforts by borrowing countries and private-sector creditors to broaden the consensus on the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets…" (paragraph 10).

Not only did the official sector only tentatively embrace the Principles, but the private sector split into "sell-side" support and "buy-side" opposition. In fact, seven private sector associations had together produced a draft "code of conduct" in January 2003 (see again table 1) and that group continued to work together until August 2004 on preparing the

Principles in cooperation with the four emerging economy members of the G-20 noted earlier. Five of the seven private associations, however, left (or were "kicked out," depending on whom you ask): EMTA (the Emerging Market Traders Association), the Bond Market Association, the Securities Industry Association, the International Securities Market Association, and EMCA (the Emerging Market Creditors Association). They represented institutions that operate in the markets that trade these securities and bond investors who hold them. Thus, the Principles that emerged represented the views only of IIF, joined by the International Primary Market Association.[30]

The financial press coverage of the launch highlighted these problems. In a detailed account of the substantive and process difficulties in preparation of the Principles, *Euromoney* focused on the role of Charles Dallara, Managing Director of IIF, who had been the driving force behind them (and for completing them in time for inclusion in the Berlin G-20 meeting). Dallara was reported to be pleased by the "breadth of private financial sector support" for the Principles, citing the over 300 members of IIF, although the reporter wondered about "the extent of the rank and file's enthusiasm." He noted that not a single bondholding institution spoke at the IIF launch and that while *Euromoney* had spoken to a large number of bondholders, all of them "either actively opposed the principles, refused to endorse them, or were too busy to pay much attention to what was going on" (Salmon, 2004). Even though the Principles seem highly skewed toward creditor interests, they apparently did not go far enough for the "buy side," who read them as having weaker protection of creditor interests than the 2003 Draft "Code of Conduct for Emerging Markets" of the Gang of 7 (see table 1).

The "buy side" has for the most part remained publicly silent on its reservations, although one group, the Global Committee of Argentine Bondholders (GCAB), issued a press release on December 2, 2004, explaining its concerns. After welcoming the progress that the Principles represented and announcing support for "most of the tenets laid out in this document," it called for "some clarification on issues relating to debtor and creditor behavior in the event of a debt restructuring."[31] The GCAB offered to be constructive in helping "to provide clarity on these outstanding issues and then to endorse the [revised?] Principles and promote their widespread adoption."

In short, while the analysis of this paper finds the Principles biased strongly toward creditor interests, the "buy side" found them to be weakening their interests. This is a dilemma that a purely voluntary mechanism cannot resolve.

[30] To be fair, at least some of the buy-side concerns that were unaddressed at the time of their departure appear to have eventually been included in some form in the text of the Principles.

[31] In particular, the GCAB expressed concern that nothing was said in the Principles to curb "aggressive use of exit consents," a mechanism by which a sovereign debtor can legally disarm a recalcitrant minority of bondholders when the majority is ready to accept a restructuring agreement. It also sought greater support for having the debtor reimburse the creditors for the legitimate expenses of the creditor committee, a point noted in an earlier footnote above (see http://www.tfargentina.it/download/GCAB%20-%20Press%20Release%20-%202-12-04.pdf).

4.2. Follow Up on Principles Implementation

Rather than seek to modify the newly minted Principles in the face of the criticism, IIF took ownership of them, and has promoted them to countries and financial institutions. It also speaks up on behalf of them to the intergovernmental community. To actively encourage implementation of the Principles, IIF has convoked two high-level committees. One is the Principles Consultative Group, which in 2006 comprised 7 senior finance officials from emerging economy governments (Brazil, China, Republic of Korea, Mexico, Russian Federation, South Africa and Turkey) and 10 senior private sector executives from commercial and investment banks, investment managers and advisors, and one large pension fund that also issues mutual funds (staff of IMF and the Federal Reserve Bank of New York participate as observers). This is the more active of the two committees, as it reviews and evaluates the progress of individual emerging economy governments in implementing the Principles and offers suggestions for improvement.

The other committee is the Group of Trustees for the Principles, which in 2006 included 28 international leaders, who mostly came from the emerging markets finance sector (3 individuals served on both committees). Ten of the 28 trustees held ministerial rank or equivalent in emerging economy governments, and an additional 3 from the private financial sector first became prominent for their service in such governments. In addition to the issuers of sovereign bonds, private sector representation was weighted, as for the Principles Consultative Group, toward the "sell side," although again with the one pension/mutual fund company represented. Also, while only one member held an official position in a developed economy, 6 others in the private sector from developed countries were well known for their past government or international financial organization service.[32] The Trustees are thus the more senior group and they are empowered to propose modifications in the Principles, as well as review their implementation and the evolution of the international financial system (IIF, 2006a, p. 7).

The first meeting of the Trustees took place in Singapore on September 16, 2006, when they received a report by the Principles Consultative Group on its activities over the year then just past. As the meeting took place in the shadow of the IMF Annual Meeting in Singapore, one is tempted to see the Trustees as a largely private-sector parallel to the IMF Board of Governors and the other group as a parallel to the IMF Board of Executive Directors. IIF serves as the secretariat of the Principles Consultative Group, preparing country reports on data transparency and investor relations, as well as on country policies for the Group's consideration. The Group then reflects on the reports and asks "IIF management to relay the Group's perspectives to country authorities and engage in dialogue toward implementation of [Group] recommendations" (IIF, 2006a, p. 9).

The IIF has thus set in motion an institutional mechanism to promote adoption of the Principles. In this regard, it may well succeed especially in building momentum to expand the extent and effectiveness of what we called here "dialogue in good times." This is not to be minimized. It appears that the spirit of the Principles was also visible in the Grenada

[32] Full membership of both groups is listed in IIF (2006a). Both groups were reported as slightly larger in the 2007 report, with comparable proportions from official and private sectors (see IIF, 2007).

and Belize restructuring deals noted earlier. However, it is hard to imagine similar success with larger debtors that face difficult economic situations in a more contentious domestic political landscape.

Indeed, in the corporate sector, when workouts are arranged voluntarily among the relevant parties, the official bankruptcy regime is just behind the curtain, giving implicit guidance on the directions in which the workout needs to go. If the parties in a sovereign workout had recourse to such a regime, the prospects for effective and fair workouts from the voluntary process would be much improved. However, no such official system currently exists.

5. CONCLUSION: A PATH TO GREATER EFFECTIVENESS AND JUSTICE

In all, one may conclude that the Principles are a mixed bag. They contain some useful guidance for debtor/creditor relations in good times, in particular regarding issues of government transparency and investor relations programs, although they missed the opportunity to call for greater creditor transparency. Their call for creditor discussion of domestic policies with borrowing governments may be appreciated, although with the caveat that the creditor discussions be among other discussions that open governments should hold regularly with all their stakeholders. Also, the Principles seem potentially useful when a loss of international investor confidence threatens a liquidity crisis, assuming that the private sector leaders that consult with the government can in fact help overcome market resistance to uninterrupted government access to its regular sources of external credit (and not overcharge for the assistance).

However, for all the reasons detailed in this paper, the Principles seem weakest in the area in which the need is the greatest, facilitating effective and fair — as well as orderly — workouts from sovereign debt crises. The "voluntary" processes in the Principles leave the players free to exercise the powers that they have. Principles that are more balanced and reliable, coupled with some form of credible and fair enforcement mechanism need to be added to the model to create incentives and pressures for participants to reach a deal that gives greater weight to the obligations of the government to its people, and not just to the relationship of the government with its creditors.

One may speculate as to why international bankers dealing with emerging markets were drawn to developing their Principles. The project gained momentum when the SDRM proposal was actively being considered and thus could be seen as a more creditor-friendly alternative. It also fit with their experience, as we will suggest now. But it under appreciated the legitimizing and disciplining role of official processes in a sovereign debt workout. We conclude by suggesting what such a role might comprehend.

5.1. Nostalgia in the Voluntary Model

Why was the international financial industry, or at least the major international commercial and investment banks that are prominent in IIF, drawn to the purely voluntary model? One may only speculate, but there could be a number of reasons. First is that the leadership among IIF members includes several alumni of the 1980s sovereign bank debt crises, where creditor committees were a basic part of the workout strategy.[33] Second is that whereas the commercial banks worked closely with their home governments and the IMF in the 1980s, especially in the early 1980s, creditor institutions in the first years of the present decade had become quite unhappy with what they perceived to be a reduced

[33] Indeed, IIF's initial essay into principles for renegotiating emerging market bond debt noted: "Formal negotiation with creditor committees remain a viable option. Recent experience demonstrates that the London Club process need not be restricted to commercial banks but can be adapted to a broader group of creditors" (IIF, 2001, p. 7). International bondholder committees also functioned in the nineteenth and early twentieth centuries, albeit in a world of less fluid communications and financial markets.

intention of the IMF and their home governments to defend creditor interests in sovereign debt crises.[34] Thus, the central thrust of the Principles is that the creditors and the debtor should work out the difficulties directly between themselves. This would require some organization on the part of the creditors. However, as some bondholders are ferociously independent, only a voluntary set of principles could feasibly win their support (as noted above, this strategy largely failed anyway to hold the "buy side" close to the Principles).

One may offer an additional hypothesis, also based on the fact that commercial bankers have been at the center of the Principles exercise. One underlying notion was that a better working relationship between a sovereign and its creditors could smooth out a crisis. Perhaps this was meant to be analogous to the way that a business owner might sometimes work with her banker to get through a difficult period. In a relationship of trust and mutual confidence, the banker would extend additional credit, taking on more risk, while the firm made adjustments to remain solvent. In fact, relationship banking works in many circumstances. It works at the level of traditional, small-scale community banks (as in some rural parts of the United States), or in the special relationships that microfinance institutions cultivate with their clients (as in myriad developing countries), or even and at least for a period of time when there is a deeper economic and social relationship (as in traditional Japanese corporate networks tied to their main banks).

But to say relationship banking "works," means only that sometimes it can resolve a difficult situation for a solvent enterprise with good prospects. Other times the firm indeed goes bankrupt and an arm's length insolvency process with credible incentives and sanctions must take over. Moreover, it seems that relationship banking in the corporate sector has itself been in long-run decline in developed countries, where the growth of securities markets and asset-backed securities has given firms of a certain size increasing ability to lessen their dependence on banks for financial resources and thus lessen the value of the "relationship." The commercial banks, in turn, have become less dependent on lending their own funds to firms and keeping the loans on their books. Instead, increasingly banks turn all types of loans that lend themselves to securitization into financial instruments that they then offload into the market, and many more commercial banks than before are now also performing as investment banks and underwriting securities, all of which makes them increasingly transaction based rather than relationship based (United Nations, 1999, pp. 125-136).[35] If financial market development and innovation have lessened the role of relationship banking at the corporate level, one should not be surprised to see a similar development at the sovereign level. Indeed, this is already happening. In short, if the authors of the Principles were thinking in terms of relationship banking, they were being nostalgic.

In fact, the concept of relationship banking as banks have practiced it with companies, *should not* fully apply at the sovereign level. The government has reporting responsibilities that preclude (or should preclude) a confidential relationship with its external creditors that a firm's management could have. Also, banks do not lend their own funds to governments

[34] In the United States, for economic and political reasons, the White House and the Treasury were openly sympathetic to the Argentine need for significant debt reduction (see Helleiner, 2005).

[35] This was not meant to be a forecast that commercial banks would disappear from corporate finance in developed economies, as they are still major developers of non-standardized lending (see Rajan, 1998).

as much as they did in the past, but rather arrange bond issues that they sell to a public market. They thus cannot operate as confidentially as when they carried the loans on their own books. Also, they cannot so easily arrange "concerted lending" by bondholders the way they did with commercial banks in the 1980s. Bondholders are very widely dispersed and have the option to sell their bonds,[36] however much at a discount, rather than become tied into a continuing relationship with the sovereign. It seems that in any large-scale restructuring, the voluntary creditor committee would have to be unusually good at "herding cats."

5.2. Adding Legitimacy and Discipline

The reason for concern about the efficacy of a voluntary sovereign debt workout under the Principles has nothing to do with the quality or commitment of the individuals involved, or even with the pro-creditor bias in the Principles as drafted. A more balanced set of purely voluntary principles would have the same defect, which is in the structure of the situation: parties with diverse and to some extent inconsistent interests and priorities are meant to cooperatively and in a purely voluntary way reach an appropriate solution to a sovereign debt crisis. The almost universal existence — and prescription — of effective bankruptcy laws at the national level to handle corporate insolvency suggests that there is no empirical — let alone theoretical — basis for putting confidence in a purely voluntary insolvency process.[37] There needs to be a mechanism to maintain the discipline of the framework for crisis resolution, which is the usual role of the bankruptcy court. This is not a job for the "invisible hand." The same structural need — if not the same solution — must surely apply for the same negotiation at international level.

And yet, all efforts to create a sovereign insolvency process thus far have been stillborn. There is great political antipathy to developing anything like a mechanism to recognize sovereign bankruptcy. One may then ask whether the international community could develop a system that delivers at least some of what a bankruptcy regime delivers. Is there some other way to increase discipline and responsibility in creditors and debtors that is less than a bankruptcy regime and more than a voluntary code of good conduct?

It seems that in fact a tentative step in a promising direction was already taken early in this decade, although it was overwhelmed by the SDRM and CAC debates. As noted earlier, in 2002, IMF proposed a set of principles for orderly debt workouts in elaborating its "good faith" criterion for lending into arrears. Originally viewed as a device to bring reluctant creditors to the negotiating table, it became in the eyes of the creditor community a device to bring a reluctant debtor government to the table to negotiate with its creditors. This appears to be something on which to build.

Three steps would be needed. First, a more complete and internationally agreed statement of what "good faith" means in the context of workouts from a sovereign debt crisis would have to be elaborated. Second, a mechanism would be needed to decide whether the

[36] In fact, many institutional bondholders are *forced* to sell defaulted paper or paper that is downgraded to sub-investment grade.

[37] See Stiglitz (2002) for a comparison of private and sovereign insolvency and the workout regimes that govern the former and are missing from the latter.

relevant parties in a specific debt crisis workout were in fact acting in "good faith." Third, the official international community — in particular, debtor governments, the IMF and other international financial institutions, and the creditor governments — would have to have pledged to be guided by the internationally agreed criteria of "good faith" and by the findings of the country-specific mechanism, and then they would actually have to do so.

The first step is to decide what the contents of the "good faith" criterion should be. As noted at various points in this paper, the IIF Principles seem biased toward the creditors. Other authors have offered other ideas.[38] This author's preference is that a broad international process with the participation of all concerned stakeholders be convoked to decide on the content of "good faith" actions by sovereign debtors, and by private and official creditors. While all relevant stakeholders should participate, the end result would have to be a text agreed by governments and reflect a genuine political consensus. Some stakeholders would perforce be disappointed. But there is a public purpose here that has to override narrow interests when they do not fully cohere with the public one. The key is to properly identify the public purpose and the principles that it should embody. The United Nations has a tradition of establishing both ad hoc and standing forums to elaborate normative standards for international economic relations. One simple way the UN General Assembly could set the process in motion in this case is by requesting UNCITRAL (the well-regarded United Nations Commission on International Trade Law) to develop a recommendation for its consideration. But other ways could also be conceived.

The second step is where we enter the issue of strengthening discipline in debt workouts. While not conceived as a treaty obligation, the "good faith" principles should not be violated lightly. But assessing whether "good faith" in fact existed could not be left to possibly self-serving interpretations by different creditors or the debtor itself. Some international authority that is held in high regard by all the players as neutral, principled and technically competent would have to reach such a judgment. Were it perceived to satisfy all these criteria, the IMF Executive Board would be the prime candidate to be that authority. Perhaps a reformed IMF, or a successor international organization that was not itself a creditor, might make the assessment. Alternatively, perhaps an ad hoc panel of wise men and women acceptable to debtor and creditor governments could be constituted when needed to interpret whether the debtor and its creditors were acting in "good faith."[39] The international discussion to elaborate the concept of "good faith" could also design the mechanism to judge individual cases.

The third step is that the IMF and other official creditors would be expected to continue supporting a debt-crisis country that was deemed to be acting in good faith. To be credible, a withdrawal of international support (other than emergency or humanitarian assistance) would have to accompany a finding by the authority of debtor government "bad faith". By the same token, a finding of debtor government good faith should signal to creditors that the international community regards the country as seeking to cooperate in resolving its

[38] In addition to the recommendations referenced in table 1, Lee Buchheit and Rosa Lastra (2007, p. 23) have recently made a concrete proposal that is explicitly in the context of fleshing out the criteria for "good faith".
[39] Several suggestions that could be reinterpreted as applying to ways to constitute such a body may be seen in the column denoted "institutional framework and process" of the comparative table of proposals for improved debt workouts in Kaiser (2008).

debt difficulties. Creditors, both official and private, would be expected to follow whatever specific debt negotiation or discussion processes they mutually deemed appropriate, as long as the processes satisfied the good faith principles. No single model need be assumed superior to all others for all situations. On the other hand, if some group or individual creditors were found not to be acting in good faith, it could constitute an assignment of blame for difficulties in reaching an appropriate workout. While it is admittedly hard to conceive what sanctions might be imposed on "badly behaved" official creditors (beyond political opprobrium), there is an opportunity in that "badly behaved" private creditors are likely to seek succor in the courts.

More precisely, it is proposed that the courts in creditor countries not accommodate uncooperative private creditors under this regime. If, for example, a speculative investor went to court in the country whose laws governed a bond contract to press his claim against a defaulting sovereign, an intervention (let us say an *amicus curiae* or equivalent brief) from the government would have weight with the judge if it said the case is progressing under the internationally endorsed workout process, that the debtor and the majority of its creditors were acting in "good faith" and that this government is committed to seeing the matter resolved through the agreed international process. The argument in such a brief would have to challenge the legal arguments made by the uncooperative investor, but its force would essentially be political, namely that a court finding for the creditor would undermine international cooperation obligations that the creditor government supported. Is this not, in fact, part of the story of Argentina in the US courts?[40]

In short, it seems that the force of the international agreement could trump individual creditor contract rights that might otherwise carry the day outside the scope of the agreement. Governments would be bound by their acceptance of the principles and process to honor findings of good faith. As regards private creditors, it is the role of the judge before whom non-cooperative claims for repayment are made to balance legal, political — and, indeed, human — imperatives in reaching her decisions. However, one may envisage one further step to make the matter even more unambiguous once the "good faith" criteria were developed. That is, a pledge to act in good faith as so defined in resolving disputes could be inserted into new sovereign bond contracts. As with CACs, it is doubtful such a contract modification would disadvantage debtors in any way or discourage lenders.[41] It would seem at least at first glance as no more odious than standard arbitration clauses in commercial contracts.

As it is, the IMF has planned to revisit its lending-into-arrears policy — and could reconsider its "good faith" criterion — as part of its medium-term work strategy. While

[40] Indeed, the United States government made a judicial intervention over a sovereign debt crisis for the third time since the 1980s when two firms holding defaulted Argentine bonds sought to capture payments by the Argentine government to the IMF. The intervention was through a "Statement of Interest of the United States," requesting that the court "bar plaintiffs from interfering with payments by Argentina to its creditors" (US Government, 2004, p. 20). In its brief, the government spoke of its "foreign economic policy" to promote "orderly and consensual restructuring of sovereign debt" (p. 2) and that the plaintiffs' intentions, in essence, were not helpful.

[41] Court challenges could still be mounted, but would likely be based on claims that one party or another did not follow the good-faith guidelines, which either might nullify the agreement or the requirement of the creditor to be bound by the good-faith principles himself.

nothing of the scale that is proposed here is envisaged (indeed, the Fund could be pressured to cede the “good faith” territory to the Principles), nothing precludes it either, or that the international community take up the matter in a different forum, as suggested above. It is a matter for international debate whether the “good faith” criterion might be the handle on which to elaborate and explicitly endorse agreed principles and processes that would raise the confidence of people in developing countries as well as creditors of reaching orderly, effective and fair workouts when sovereign debt crises become unavoidable. It is only hoped that the ideas presented here might stimulate thinking on ways to improve on the situation as it exists today.

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