Initiative *for* **Policy Dialogue**

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Introduction

The Case for a New International Reform Effort

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Why this? Why now?

Many people working on international financial policy have argued that the world does not need to develop a new way to handle sovereign debt crises. Yes, they might say, the international system operated less smoothly and consistently than one might like, but it did settle the debt crises of the 1990s and early years of this decade, and the cases that were still open in the middle years of the decade were in the midst of a cooperative process that would lead to settlement. Yes, they would admit, there are 'vulture' funds that take advantage of the debt reduction agreed by cooperating creditors and it is not fair that they succeed in obtaining full repayment in court actions. Yes, as well, not all official creditors abide by the terms of relief agreed by the major creditors, thus 'free riding' like vulture funds on the concessions given by others (see IDA and IMF, 2008). But these problems are at the margins of the debt-restructuring process; considerable debt relief has been accorded both by private and official creditors. Policy-makers—if not their civil society critics—have felt sanguine.

In some respects, international policy toward the sovereign debt of the poorest countries has evolved over the past decade. In 2005, after protracted struggles and widespread civil society anti-debt campaigns, the world's donor governments offered the poorest countries the deepest debt reduction in history, by agreeing to cancel almost all the debt-servicing obligations of the Heavily Indebted Poor Countries (HIPCs) to the International Monetary Fund (IMF), the World Bank, and the regional development banks, as well as bilateral debts. Servicing of multilateral debt had heretofore been sacrosanct, but the Multilateral Debt Relief Initiative (MDRI) changed that policy, acknowledging that the

poor countries that benefited from it needed to be relieved of the multilateral debt-servicing obligations that were impeding their progress toward the Millennium Development Goals (MDGs).

At the same time, middle-income countries, such as Uruguay and the Dominican Republic, restructured their sovereign bonds through fairly amicable market-oriented debt swaps, with the last major contentious restructuring of the external debt of a middle-income country essentially resolved in 2005 when a sufficient majority of Argentina's bondholders accepted its unilateral offer to swap defaulted for new bonds at a heavy discount. Later that same year, Nigeria negotiated an unprecedented combination of debt forgiveness and prepayment with its government creditors. The middle years of the decade were also a period of strong global economic growth and buoyant international commodity prices, and developing countries along the spectrum of income per capita took advantage of the opportunity. They boosted foreign exchange earnings, built up their official reserves and in some cases even paid down a portion of their debts ahead of schedule. In this environment, sovereign debt difficulties could be thought a subject for historians, not policymakers.

Despite the advances made, we did not think policymakers should have been sanguine before the recent economic crisis, and we certainly do not think they should be so now. Our view is that it is in the nature of market economies, especially economies open to international financial flows, to be subject to periodic debt crises. It has always been thus, and we have no reason to believe it will be otherwise in the future. Viewed from the global economic crisis of 2009, the question is not whether countries will need to restructure their sovereign obligations in the years ahead, but how many of them will need to do so. We have not been alone in this concern.

In particular, in March 2009, the IMF analyzed the debt situation of seventy-one low-income countries (LICs) and classified twenty-eight as high risk under its baseline projection. The Fund then looked at the prospective consequences of potential declines in foreign direct investment and aid and added three more LICs to the category of 'high risk' of debt distress (IMF, 2009a: 43 ff.).[1] In another study, the Fund also expressed serious concern for middle-income countries that it classified as 'emerging economies'. In contrast to the LICs, external borrowers in these countries—governments, banks, and major corporations—mainly draw on private sources of funds. These flows declined substantially in 2008, with many countries experiencing large capital outflows. The Fund Staff warned of 'severe financial and economic dislocations' in some emerging economies, which would 'weigh heavily on growth and, in some cases, trigger external crises if not addressed' (IMF, 2009a: 18). Moreover, the Fund expected this situation to be 'prolonged compared to past episodes [in the 1980s and 1990s]' (p. 21). And, while financial flows to private entities were expected to bear the brunt of the shortfall, 'emerging market sovereigns would suffer significant spillovers from corporate and banking sector dislocations' (p. 22). Indeed, it was anticipated

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that governments could be called upon to guarantee or actually intermediate loans to resident corporations and to help recapitalize domestic banks, causing a private sector crisis to turn into a sovereign one.

Warning flags that are being raised refer to countries that recently emerged from debt crises or emerged from them more than a decade ago, but also countries that have not experienced debt difficulties in the past.[2] We cannot know at this point how long the global crisis will last, but we fear that countries that do slip across the line into debt difficulties during this period will have a difficult and protracted path to recovery. Although countries eventually emerge from such crises, it is usually only after a sharp economic recession or a long period of stagnation or slow growth, with slippages on all sides and frequent delays and refiguring of the adjustment program. Ultimately, they are able to return to their normal sources of financing, but in many cases they are left with high debt burdens and a significant probability of having to restructure again in the near future. This is hardly sufficient. Even the initiative for the HIPCs, which accepted the idea of a 'fresh start' as the goal of relief when it was launched in 1996, did not sufficiently lower the debt burden for the selected countries until the MDRI of 2005, as noted above, and then only as a one-time operation for the included countries (see Chapter 9).

An essential feature of our discussion is the sovereign nature of the debtor governments. Lending to members of this debtor class has traditionally been deemed the least risky of credits because governments' powers of taxation and foreign exchange management give them the ability, in principle, to cover their financial obligations. However, there are times when the social costs of doing so can be enormous. Policymakers may thus become unable politically or administratively to mobilize the power to direct the requisite funds to debt servicing, may be unwilling to do so, or circumstances may have so hurt the population that any effort to raise additional revenue would be an act of political suicide. How much stress governments of emerging and low-income countries will sustain rather than default on their sovereign debt is an especially pressing question in the current economic environment. Already, Ecuador has selectively defaulted on two bond issues in late 2008 and early 2009, albeit because of political judgments about the 'illegitimacy' of the loans, rather than because it ran out of cash. Nevertheless, the President's popular rallying cry is quoted as 'Life before debt' (Reuters, 2009).

The need to discuss sovereign insolvency highlights another characteristic of sovereign lending, namely, that to speak of a 'bankrupt' government is to use a metaphor. Sovereign debts are unlike any other. Creditors cannot force an insolvent government to be wound up or take possession of its remaining assets.[3] There is no internationally endorsed system of law or procedure for how to address sovereign bankruptcy. In fact, jurisdictions differ in the legal specifics of how to handle a sovereign's default. Private foreign creditors of a defaulted sovereign can go 'forum shopping' to find the most creditor friendly

jurisdiction in which to press their claims. However, they only collect on their claims, even when they manage to win in court, if the sovereign itself decides to accept the judgment and pay. For this reason, and because some of the debt is owed to official creditors, debt has usually been restructured through informal negotiations and 'voluntary' processes. In this regard, the treatment of sovereign debt crises is 'political' at its core, in the sense that it involves relations among states even if private entities are part of the deal. Our concern is that this political process should no longer be ad hoc but be explicitly shaped so as to be effective, efficient, and fair.

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

The question addressed by this book is whether or not a more comprehensive, timely, effective, and fair mechanism ought to be in place to handle whatever sovereign debt crises do arise, not only over the next year or so, but over decades to come. We believe that the international community can design a superior mechanism to handle such crises more efficiently and humanely. Many countries have designed national insolvency regimes not only for corporations that wind up hopelessly bankrupt entities, but that also seek to salvage firms that with reduced debts can survive as going concerns. The objective in the latter cases, as with insolvent sub-sovereign entities or households (which cannot be 'wound up'), is to give a second chance, a 'fresh start', and a 'clean slate'. The ad hoc, partial, and at best loosely coordinated system for addressing sovereign debt crises does not deliver such outcomes.

The existing system may be characterized as embodying informal and imperfect coordination of the debtor and its creditors, usually by the IMF under the guidance of the Group of 7 major industrialized countries. The latter countries have set the overall policy directions for the IMF and the other institutions involved, such as the so-called Paris Club, where debts owed to governments are restructured. The system assumes a developing country government in debt distress will adopt an IMF-approved macroeconomic adjustment program, that the program will be effective, and that all the relevant classes of creditors (banks, bondholders and suppliers, government creditors, and multilateral

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institutions) will cooperate in providing the overall amount of relief and financial support deemed necessary in the Fund documents. These assumptions never fully held, and what confidence there was in the system was severely rocked by how the East Asian, Russian, and Argentine crises from 1997 to 2005 were handled. Indeed, during this period, the focus of the major creditor governments (and thus the IMF) shifted from the bailouts of the mid-1990s to 'bail-ins' (i.e., debt restructuring) of private creditors. While this change irked the lenders, many debtors were also unhappy, most notably Argentina, which settled with its bondholders without the IMF (see Chapter 8 in this volume). By the end of the period, the international financial industry developed a 'code of conduct' that if adopted could be read as offering sovereign debtors to replace the IMF with direct private creditor–debtor discussions when debt crises loom (see Chapter 14). Like the status quo, this approach would also not meet the systemic need we are identifying here.

There is nothing immutable in the current approach to resolving sovereign debt crises. It arose in the political and economic environment created after the Second World War. Before the war, the internationally recommended means to resolve a sovereign insolvency that could not be addressed informally was intergovernmental arbitration.[6] Creditors at the time were primarily bondholders, as is increasingly the case today. Typically organized into creditor committees, the bondholders first sought to collect on the defaulted claims of sovereign borrowers themselves, and when this failed, sought assistance from their own governments. Representatives of the creditors' governments then negotiated with the debtor or pled the creditors' case in an arbitration proceeding. On occasion, governments went so far to support the creditors as to intervene militarily in the debtor country.[7] The debt crisis workouts under this regime tended to grant sovereign debtors greater degrees of relief from their private creditors than in the current system, but it also generally took longer to settle the creditors' claims, during which time interest arrears typically accumulated, sometimes exceeding the original defaulted principal, and there were other costs associated with the delay in 'curing' the defaults (see Suter and Stamm, 1992).

The point here is not to evaluate the pre-war years but, as mentioned above, to remember that the current system is the product of a specific era. The practice of having developed countries directly represent the interests of the creditors from their countries has been deemed unacceptable under the post-war system. Nonetheless, according to some analysts, powerful governments indirectly represent creditor interests through their influence in multilateral institutions. Representatives of private creditor associations would strongly dispute that assertion, complaining that the international financial institutions (IFIs) are political organizations that favor the debtors—or at least some of them—for foreign policy reasons and that the IFIs (which are also creditors in their own right) defend their own interests rather than those of private creditors. If none

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of the stakeholders are happy with the current system, perhaps they should think about changing it.

This book is the culmination of a project in which the Initiative for Policy Dialogue of Columbia University invited experts in law and economics from developed and developing countries, including voices from academia, past policymakers, the private sector, and civil society, to contribute their perspectives on developing country debt crises. The project organized a conference jointly with the United Nations Secretariat in November 2004, in which most of the authors in this book participated.[8] There followed an extensive dialogue over almost four additional years between the project directors, who are the editors of this book, and the chapter authors. The result, we believe, embodies a comprehensive analysis and a diversity of views. We essentially wish to present a framework and a selection of views to rekindle a debate in the international community that might lead to the creation of a sovereign debt-restructuring mechanism rather than design what mechanism should be put in place, though in the concluding chapter we do offer some suggestions of our own in that direction.

Some of the chapters seek to clarify the international and borrower country policy frameworks through conceptual analyses of borrowing and bankruptcy. Other chapters examine the history of international debt workout efforts or individual debtor country experiences during the past half century or so. Others seek to shed light on the political processes and substantive content of specific efforts to reform the way workouts from sovereign debt crises are organized. The authors of these chapters were drawn to a rich variety of policy conclusions and recommendations.[9] In the following, we summarize the analyses and experiences in those chapters, supplementing them with some of our own observations, yielding what we think to be a coherent case for sovereign bankruptcy reform.

The analytical framework for debt policy

The first step in analyzing policy issues in the international treatment of developing country debt is to develop a conceptual framework for the analysis. In this regard, Joseph Stiglitz in Chapter 2 focuses on what lessons might be drawn for sovereign insolvency from the principles underlying national policies for corporate or personal bankruptcy. He then develops a framework to analyze alternative mechanisms for sovereign debt restructuring. One also needs to ask how much debtor governments can reasonably be expected to mitigate the risk of debt crises by themselves, which turns the focus to principles and practices of debt management of the governments of developing countries, which Chapter 3 by Stijn Claessens and Chapter 4 by Ugo Panizza address.

Stiglitz draws parallels between private and government bankruptcy and finds that the special nature of governments makes it complicated, but not impossible, to define an attractive sovereign counterpart to national bankruptcy laws. Stiglitz notes that different processes for dealing with insolvency, as well as their outcomes, can be more or less efficient and fair. He argues that countries adopt domestic bankruptcy laws for both efficiency and equity reasons, and that the goal of an effective bankruptcy regime should therefore be, both *ex ante* and *ex post*, efficient and equitable. *Ex post*, an efficient bankruptcy regime should minimize the loss associated with the restructuring, and raise national output and income. It is in the interest of society to keep the physical and human assets in an insolvent firm together as long as the firm is worth more than the salvage value of those assets. *Ex ante*, the bankruptcy regime affects how borrowers behave and how creditors assess the riskiness of investment decisions. Because of this, the rules of the bankruptcy regime help shape the probability of default, and of recoveries in the event of default, and thus affect the cost and extent of borrowing. *Ex ante*, a properly balanced regime should deter borrowers in trouble from undermining the sustainability of their firms by excessively postponing their moment of default. On the other hand, balance also requires that creditors feel sufficient confidence that their property rights in a loan will be protected to undertake their lending function. Considerations of equity include that all creditors (including minority shareholders) are treated fairly during bankruptcy. In addition, equity considerations include that borrowers be protected from lenders who would exploit them, but also protect creditors from managers who would strip the assets of a firm going bankrupt.

Without a bankruptcy regime, parties would have to rely totally on contract law, which would be costly, as it is impossible to write contracts that anticipate all contingencies. Negotiations to handle unforeseen aspects of a bankruptcy would be inevitable. Also, without bankruptcy law, too great a burden would be placed on contracting parties to monitor all other contracts of their counterparty and how they might impinge on their own. Finally, strategies of one side or another to increase their gains or reduce their losses in an unsupervised post-default negotiation could lead to costly delay in reaching a settlement. In short, the 'transaction costs' of addressing insolvency can be much reduced with a proper set of laws, a bankruptcy court to adjudicate them, and incentives to promptly bring the parties to a resolution that they would regard as fair.

While there are parallel efficiency and equity arguments regarding government insolvency, lending to governments is distinct. Such loans are usually made without collateral and there is no legal mechanism to enforce repayments comparable to state enforcement of a court finding on a private loan contract. There is instead only a belief that governments will fully service their debts to ensure continued access to credit, which Stiglitz acknowledges is an uncertain incentive. At the same time, current sovereign bankruptcy practices create an

incentive for countries to over-borrow during boom periods and for creditors to lend more to a government than it may be prudent for the government to take on. The question Stiglitz then poses is how to design a sovereign bankruptcy system with desirable efficiency and fairness incentives, a question on which we focus in our concluding chapter.

In Chapter 3, Stijn Claessens analyzes whether governments actually tend to borrow excessively and not take the steps needed to protect themselves from debt distress, noting that there are direct outlays and opportunity costs in any effort to mitigate risk. Drawing on both the economic theory of contracts and practical experience, he concludes that the problem is not so much that sovereign debtors borrow too much but that they have to bear too much of the risk of external borrowing. He thus calls for additional—albeit not unlimited—risk sharing with creditors.

The author observes that governmental authorities in developed countries that face high degrees of international volatility do not regularly use hedging instruments, from which he concludes that lack of access to them at reasonable cost is not the only issue that limits their use in developing countries. In addition, he rejects the moral hazard claim that debtor governments accept the risk of default because they expect official bailouts, as their policymakers know that the funds the international community makes available in practice are too little, delivered too late and under too strict conditions to serve as a crisis-stopping tool. Rather, he points to the low political payoff to domestic policymakers (owing to low economic returns in the short run) from a large effort at crisis avoidance. And yet, he believes, better crisis prevention is possible.

Claessens calls, first, for better government debt management, which includes examining whether contingent liabilities from public/private risk sharing might be altered in ways that ease public responsibility. He also recommends that governments better coordinate their relevant official entities that have responsibilities for foreign liability and asset management. Other proposals would provide better risk-mitigation options for the sovereign debtor. In this regard, he suggests that governments consider issuing their bonds with interest payments indexed to output or commodity prices. Acknowledging that the market has not shown interest in such instruments, he calls on the international financial institutions to do more to promote them, including creating new indices that governments might use in fixing the interest payments on bonds. He also suggests that IFIs could issue their own index-linked bonds to help build market interest in such instruments.

He calls on the institutions as well to add contingent financing mechanisms to their own standard loans to support countries when they face external shocks. In particular, he calls for indexing loans of the World Bank's International Development Association to the growth of national output. Not only would this strengthen the World Bank's pro-growth incentive, but it could reduce the need for multilateral debt relief for poor countries when they are

hit by recession; moreover, it would not be difficult for the Bank to hedge these additional risk exposures. We would add that indexing IFI loans to output has a further benefit when the loans accompany structural adjustment packages: the IFIs would share the risk of the effectiveness of their policy advice—i.e. the size of the interest and principal repayments would be linked to the effectiveness of the policies, better aligning incentives.

Finally, Claessens suggests the World Bank could offer financial hedges to countries without access to financial markets that otherwise provide them, although he notes the Bank would have to reduce internal disincentives that currently exist to using such programs.

One recent strategy of debtor countries to mitigate the risks of sovereign debt has been to substitute domestic for external debt. Middle-income countries with domestic securities markets have increasingly floated domestic bond issues in lieu of external borrowing, while even low-income countries have covered shortages in revenues (or delayed aid flows) with domestic debt, typically placed with banks. Ironically, the governments of many low-income countries have also issued domestic debt as part of their effort to counter the inflationary potential of a surge in aid inflows. This is because a surge in aid inflows can put upward pressure on local currencies, as the foreign currency is converted into domestic currency. This has the effect of making the country less competitive. Policymakers have attempted to prevent this from happening by buying the foreign currency inflows that are not needed for imports and adding them to reserves. However, Central Banks pay for the purchases of foreign currency by, in effect, printing additional local currency. The government or Central Bank often seeks to counteract the resulting increase in the money supply by selling an equivalent amount of domestic currency debt instruments, thereby removing the domestic currency from circulation. Unless the Central Bank is already holding a significant supply of Treasury bills, the government needs to issue them. In other words, the increase in aid has the perverse effect of leading to a buildup in domestic government debt. It is ironic that just as the international community has moved to replace loans with grants in an attempt to avoid developing country debt crises, the policy to manage these inflows is leading to a new buildup in debt. One implication of this is the need for a new macroeconomic policy framework for managing aid inflows.[10]

In addition, as the share of domestic debt in total government obligations rises, it becomes increasingly important to consider the restructuring of domestic debt as part of any workout mechanism for addressing sovereign debt crises. But then, what one means by ‘domestic’ debt matters, as it has consequences for how it would be treated in a debt workout and the risks it poses to fiscal sustainability. As Ugo Panizza emphasizes in Chapter 4, it matters if domestic debt means debt issued in local currency (at home or abroad) or to local investors (in domestic or foreign currency) or governed by local law (also in domestic or foreign currency). From the perspective of organizing a debt

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workout, the governing law is the most important issue, while from an economic sustainability perspective the currency of the obligations is paramount. Indeed, Panizza asks if countries are in fact reducing their risks at reasonable costs. For low-income countries, external debts are long term and carry concessional interest rates, and substituting domestic debt for foreign can be relatively expensive. Local debt generally has a shorter maturity than much of the external debt, and therefore has to be refinanced more frequently, so that countries increase rollover risk as they reduce foreign exchange risk.

For countries with access to financial markets, the trade-off between external debt with currency risk and domestic debt with shorter maturity structure and thus larger rollover risk is more complicated. The extra expense of local currency debt may be considered an insurance premium for the reduced currency risk. However, countries will in any case want to develop the local market for domestic currency sovereign debt in order to facilitate development of the domestic capital market, where government bonds traditionally serve as benchmarks for pricing corporate securities. There is, however, a caveat: deeper domestic bond markets have traditionally come with a policy of external capital controls, as in India. In recent years, many countries eliminated these controls, leading foreign investors seeking yield to include an increasing share of locally issued domestic currency bonds in their portfolios. Given the size of external flows compared to the local markets, the result is that local markets can become flooded during boom periods (making it very difficult for Central Banks to manage monetary policy). Investors may also lose confidence during bad times and pull their money out of the country, causing increased volatility in the local markets. Panizza suggests the foreign funds may be less flight prone than in the past, as investors appreciate that domestic sovereign debt should be less subject to default than external debt. One reason he offers is that governments might hesitate longer to restructure domestic debt because large quantities are typically held by local commercial banks and defaulting on such debt could set off a banking crisis. Nonetheless, domestic defaults do occur, as in Russia in 1998 (see Chapter 7).

Panizza concludes that there is an 'optimal' split of domestic and foreign debt and that finding where that optimum lies involves balancing trade-offs, as there are risks in each type of debt. He thus calls for additional technical assistance to strengthen debt management capacity in debtor countries to help their policymakers manage their individual situations.

Crisis experiences when most credits were private

While Claessens and Panizza point to ways to reduce the risk of sovereign bankruptcy, they do not claim they can eliminate the risk, and so the question Stiglitz raised of how best to organize workouts from sovereign bankruptcies

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remains. To help answer this question, the place to start was to ask how workouts have been arranged in the past. In this regard, because the practices have been so different for treating problem debt owed to private as opposed to official creditors, we need to consider them separately. We first look at how defaults to private creditors have been handled. Chapter 5 by Luis Jorge Garay Salamanca looks back to the 1980s and at how the international community addressed the debt crises of countries that were primarily indebted to international commercial banks. In Chapter 6, Shari Spiegel analyzes the workouts from unsustainable bond debt in the 1990s. We then look deeper at two cases: in Chapter 7 Sergei Gorbunov takes us through the Russian default and recovery in the late 1990s, and in Chapter 8 a team of Argentine scholars examines their country's experience in the 1990s and early 2000s, which included the largest sovereign default in history.

By the 1970s, international banking had developed syndication mechanisms for mobilizing large sums from multiple banks for lending abroad, notably to developing country governments. When the latter found themselves unable to service this debt, new modalities were devised to restructure it. This began with the onset of payments difficulties in Mexico in August 1982. The realization that the world's main money center banks were dangerously overexposed started off the development of a mechanism to treat distressed bank debt. As Garay describes it, the key authorities of the main creditor countries and the IMF oversaw the effective cartelization of the international banking sector. The policymakers used various modalities of persuasion to ensure that the systemic interest took primacy over individual bank interest, and in the process guided the establishment of the 'bank advisory committees' (or so-called 'London Clubs') to renegotiate the debt of individual debtor countries in crisis—a practice that continues as needed today. At the same time, these authorities discouraged the debtor countries from pursuing their own collective approach, not least by insisting that each country's debt difficulties be addressed separately through the 'case-by-case' approach of IMF-endorsed adjustment-cum-workout programs, which in the latter case involved through most of the 1980s only a rescheduling of debt service.

Garay describes how the initial policy, which emphasized concerted refinancing of obligations as they fell due, was superseded in 1985 by the 'Baker Plan', which sought multi-year relief packages and focused on fifteen countries in which the major banks had large exposures. The delayed recovery of the debt-servicing capacity of the debtor countries was no longer ascribed to the global recession of the early 1980s, but to the 'structural' problems of the debtor countries. This now required greater World Bank involvement, 'structural adjustment' lending, and longer-term debt rescheduling. However, economic recovery resisted these efforts too.

By 1989, it was clear that the adjustment programs in the Baker Plan had been under-funded and that the banks were unlikely to ever fully collect on their

loans. Meanwhile, shareholders, regulators, and management wanted the banks to move on. The 'Brady Plan' was then introduced as a means to reduce the bank debt outright and move it off the books of the banks by swapping it for bonds at a discount, albeit with certain guarantees, which were funded with loans from the multilateral institutions. Thus, the net amount of debt reduction was small or nil (as obligations to official creditors grew while impaired bank debt fell). Nevertheless, the debt crisis was regarded as solved and private funds flowed back into the countries. Looking back, a lot of wealth had changed hands during the 'lost decade' of development.

The era of syndicated bank lending to developing countries came to a close in the early 1990s, as 'Brady bonds' led the rebirth of the international sovereign bond market. However, while bonds had largely escaped restructuring in the era of big bank debt, history warned this would not last. Garay's story ends with the growing realization that, however imperfect, the mechanism for restructuring international bank debt was not going to be readily applicable to highly dispersed and disparate bondholders holding marketable financial instruments.

There are several cautions from this experience for today's debate. First, because the nature of the crisis was not correctly assessed for many years, it took over ten years to resolve, in what the United Nations Economic Commission for Latin America and the Caribbean called the 'lost decade' of development. Second, the final resolution, the Brady Plan, avoided establishing a more general framework or statutory approach for subsequent debt crisis workouts. Thus it did not provide a helpful precedent for the future. And third, as the net amount of debt reduction was minimal, the way was paved for a series of crises in the following decade.

As it turned out, there were quite a number of restructurings of developing country sovereign bonds in the 1990s and early 2000s. In Chapter 6, Shari Spiegel looks at the debt restructurings during that period in the context of the development of the overall international market for bonds issued by developing (or emerging market) countries. She assesses the outcome of the international process for sovereign debt workouts, not by analyzing traditional debt ratios and debt sustainability models, but by looking at the flipside: how much creditors were able to recover on their investments when restructurings took place, and how the debt workout process affected risk sharing between the debtor and its creditors.

Spiegel starts by observing that—with a few notable exceptions (such as Argentina and Russia, discussed below)—most of the restructurings during this period were considered successful because the processes were relatively quick and orderly. However, few of these agreements actually reduced the countries' debt burdens to a significant degree. She finds a marked difference between the cooperative and non-cooperative debt workout cases. In the instances of contentious and disorderly workouts, typically referred to in the market as 'unilateral defaults', such as by Russia in 1998 and Argentina in

2001, creditor losses could be significant. In contrast, the consensual, market-based restructurings did not substantially reduce the debtor governments' obligations. Although they can be seen as useful rollover operations to manage 'bumps' in the debt-servicing schedule, they did not solve the problem when debt levels were excessive. In these cases, the cooperative workouts did not provide the 'fresh start' that is the desirable outcome of a debt workout.

Spiegel points out that the consensual restructurings generally took the form of swaps of old bonds that the debtor government was having difficulty servicing (or on which servicing had been suspended) for new bonds. In most cases, creditors agreed to lengthen maturities, but did not reduce their claims. Because the swaps were voluntary, the terms on the new bonds had to be attractive enough to induce creditors to participate, so that issuers generally had to pay higher interest payments on the new bonds to compensate creditors for the longer maturities. Since there is often uncertainty surrounding the issuer's future ability to repay its debt at the time of the restructuring, the size of the payments necessary to induce creditors to extend maturities can be quite large.

Spiegel finds that the amount investors ultimately recover in the restructuring is significantly higher than seen in the usual measures of recovery values used by the rating agencies and financial analysts, which are based on market prices. This is in part because the usual measures rely on the discount factor at the time of (or thirty days after) the default, which can be extremely high due to uncertainty and risk aversion. They also are not necessarily good estimates of the amount the creditor will ultimately receive—or the debtor will ultimately repay, which is the more important element for the issuer's ability to achieve a fresh start.

Using an alternative approach to that basing recovery values on market discount rates, Spiegel estimates longer-term total returns for investors who held bonds through a restructuring, and finds that, on average, investors did not suffer losses but actually tended to earn positive returns on their initial investments. Even in cases when investors experienced losses over a short time period, measured from the time of default, the high yields paid prior to the default meant that investors earned positive returns when viewed over a longer time horizon. Overall, the difference between the market price-based estimates of recovery values and the amount that investors ultimately recovered is found to have been significant, especially in the cases of consensual workouts.

Spiegel then asks whether the premium bondholders demand to compensate them for uncertainty during periods of crisis is found in the broad market data. If this is the case, one would expect to observe that emerging economy bonds, as a whole, pay investors a larger return over time than does a broad portfolio of market instruments (the overall risk of which is reduced by diversification). Spiegel tests this hypothesis by analyzing returns on investments in emerging market debt against returns on the main market risk factors, which would together determine the return on the broad and diversified portfolio. She

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finds that emerging markets have indeed paid investors a significant excess return that is non-diversifiable and is uncorrelated with the returns paid on other market risks. In other words, emerging market issuers have had to pay a premium to bondholders to overcome the high level of risk they associate with emerging market debt.

Spiegel concludes that the uncertainty surrounding the restructuring process could be one of the causes of the substantial risk aversion found in the emerging economy debt markets. As the excess return for investors is at the expense of developing countries in distress, she calls for clearer rules of the game for sovereign bankruptcy.

Besides the degree of aversion to risk, one might also ask about investor perception of risk. The 1998 crisis of the Russian Federation illustrates something about investor sentiment. Russia was the one country that international investors thought was too important strategically for the major powers to allow default. They were wrong. However, three years after its default, Russia was able to reaccess the capital markets, and was upgraded to investment grade two years after that, which suggests that markets are forward looking (or have short memories), so that countries are not necessarily penalized for past defaults.[11]

Gorbunov traces Russia's descent into bankruptcy, starting from the collapse of the Soviet Union in 1992 to the sovereign default in August 1998, and the recovery strategy that followed. He ascribes the rapid accumulation of debt before the crisis to the macroeconomic stabilization strategy that was meant to contain the spurt of very rapid inflation as the Soviet Union disintegrated. Russia followed an orthodox strategy of tight money and a relatively fixed exchange rate, the latter acting as a nominal anti-inflation anchor. However, the government also ran unconstrained fiscal deficits, which it financed by borrowing from domestic and foreign sources. By the eve of the crisis, as domestic wealth holders increasingly moved their funds offshore, foreign investors were still lending directly through purchases of international bond issues and domestic currency Treasury bills and bonds, for which they often hedged the risk of exchange rate devaluation through currency swaps with local banks. The IMF continued to support Russia until right before the default, which may have been one source of the confidence that some investors in the international financial markets had that Russia was strategically too important to fail.[12]

The post-default, post-devaluation, economic recovery program was built on offering better market incentives on tradable goods from less distorted domestic prices (and, somewhat later, by strengthening international export prices) and easier monetary policy, which together stimulated production and income growth. In addition, the debt burden was eased through a restructuring of both foreign and domestic debt. Estimates suggest that the external investors recovered between 16 and 45 cents on the dollar, largely owing to the ruble depreciation (there was no nominal write-down in ruble terms, though

shorter-term debt was swapped into mostly longer-term securities). The foreign debt was restructured after a partial default that greatly upset international financial market expectations, as Russia continued to service its Eurobonds but ceased servicing Soviet-era debt. The author explains the legal and political rationale and the workouts agreed with government and banking creditors, the net result of which was to convert all remaining Soviet debt to obligations of the Russian Federation. The significant 'haircut' for private creditors in the sovereign debt workout helped advance the necessary fiscal adjustment, along with higher tax revenues, not to mention expenditure cutbacks in addition to the reduced interest outlays.

By 2001, Russia again had international market access, as already noted. Moreover, capitalizing on strong oil prices, Russia substantially reduced its foreign debt both by not rolling over maturing loans and making advanced repayments of obligations to official creditors. Indeed, Gorbunov lauds the reduction in the amount of debt outstanding, saying that Russia's dependence on a limited range of commodity exports with volatile prices requires carrying less foreign debt than standard indicators would say is 'sustainable'.

The other case on which we focus here is Argentina, which, like Russia, had committed itself to a fixed exchange rate—a policy decision that could not be sustained indefinitely. The question observers had asked of Argentina through the late 1990s was how long and how much could the country punish itself to maintain the peg and avoid default. As Mario Damill, Roberto Frenkel, and Martín Rapetti underscore in Chapter 8, the answer was too long and too much.

In their view, the key to understanding the leadup to the Argentinean debt crisis was the particular anti-inflation and growth strategy—followed first in 1979–81 and in a more radical way in 1991–2001—of fixing the exchange rate, liberalizing the economy, and fully opening it to international financial flows. The authors show that funds first rushed into Argentina to take advantage of high nominal interest rates in an inflationary environment, which also helped spur economic recovery. However, later the funds fled the country as confidence in the sustainability of growth and of the exchange rate regime dissipated owing both to real appreciation (domestic inflation, while slowing, still exceeded international rates) and vulnerability to exogenous shocks in the context of a growing foreign debt burden. In the early stage of these currency regimes, debt growth was mainly private, but then government borrowing became essential to maintain the exchange rate when the private funds became more cautious and then fled. Ultimately, the process ended with devastating economic consequences, on both occasions.

The authors dispute the charge that Argentina's problem in the 1990s could be traced to fiscal profligacy that then undermined confidence in the currency regime. They show, instead, that the government ran a tight budget policy on the items under its control. However, the fiscal balance became prisoner of the higher interest payments on the debt, due to a higher risk premium following

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the East Asian and Russian debt crises in 1997–8, and the budget consequences of the partial social security privatization adopted in 1994. Indeed, when economic recession began in Argentina in 1998, with neither exchange rate nor monetary policy tools available, the response had to fall to fiscal policy, albeit in an external environment already worrying about the growing debt. The government response was a policy of fiscal contraction to try to boost confidence, reduce Argentina's risk premium on interest rates, and stimulate recovery. In fact, it only deepened the recession, leading to increasingly desperate attempts to cut the budget deficit as the economy spiraled downwards. Moreover, government net foreign borrowing had become essential to add to foreign exchange reserves (under its currency board a reserve contraction would also lead to a contraction of domestic credit). Finally, not only had private capital stopped coming, but it began to flee in increasing amounts, so that the collapse of the currency board and default became inevitable.

In early 2002, finally relieved of the currency board and with most external debt-servicing payments suspended, economic recovery began. As in Russia, a sharp fall in the exchange rate stimulated import-competing industries and exports (helped also, somewhat later, as in Russia, by stronger international prices). Fiscal balances also strengthened appreciably, owing to new taxes on exports (to capture some of the gains for society of the strong improvement in exporter incomes due to real exchange rate depreciation) and rising tax revenues more generally as the economy began to bounce back.

However, the domestic financial system—indeed, business and household finance as well—had been severely distorted by the currency board's overvalued exchange rate and virtual dual currency system (e.g., contractual obligations could be written in dollars and transacted in pesos) and thus the adjustment to the devaluation and return to a more normal financial system was painful. It was also expensive. New financing for the banks (and later for compensating savers for losses), coupled with the need to bail out Argentina's provinces and honor past-due government obligations, caused the government to add $28 billion to its debt in the first two years of the recovery (it totaled $179 billion as of end 2003).

In 2005, however, four years after default and following years of contentious relations with various groups of bondholders and the IMF, the massive and unilateral external bond swap reduced the debt by $67 billion. This was a formidable 'haircut'. Roughly a quarter of Argentina's foreign bondholders did not accept the swap. Argentina's Congress nullified the remaining old bonds outstanding and treatments in the US courts did not resolve the situation in favor of the creditors. Argentina tabled, nonetheless, new proposals for regularizing the outstanding claims in 2008–9.[13]

In short, one would be hard pressed to say Argentina's debt workout was either 'efficient' or 'timely'. One might say it was 'fair' in light of the large size of the overall reduction in the debt, but all Argentina's multilateral creditors have

been repaid in full and on time (or in advance), and all the losses have been borne by private creditors, including thousands of small household investors in Europe who took risks they most probably did not understand.

Crisis experiences when most credits were official

In the early years after the Second World War, the international bond market of the pre-war era lay moribund and the international banking sector had yet to recover sufficiently to begin lending in significant amounts. Instead, most international credits, particularly for developing countries, were inter-official loans, lent directly or guaranteed by one government to another (the new multilateral institutions also lent exclusively to governments). By 1956, the government creditors discovered they needed a mechanism to deal with debt difficulties of their sovereign borrowers. They sought to organize debt restructurings so that the creditors would share the burden equitably among themselves, and also—in their own interest—accord only as much relief as they jointly deemed necessary. Thus, the Paris Club was born. This is the focus of Enrique Cosío-Pascal in Chapter 9.

The Paris Club treats the debt of both middle-income and low-income debtor countries, but today most of its policy focus is on the latter. Indeed, in a protracted series of steps it offered increasingly deep debt or debt service reductions to its poorest clients. We see how this operated in a single country in Chapter 10, where Matthew Martin describes the long path that Ethiopia had to travel before receiving sufficient relief. Henry Northover then takes the story to its most recent step in Chapter 11, showing how in responding to the civil society critique of the inadequate relief accorded to the poorest countries, the creditor governments in essence merged their debt policies into their foreign aid policies. As all inter-official debt workouts entail relations among governments (and the international institutions they own), they are driven by foreign policy principles and politics. This is not a problem, but rather an opportunity for stronger cooperation for development.

As to the Paris Club itself, Cosío-Pascal describes the unique way the negotiations are carried out, with the debtor in essence as supplicant to the creditors who then announce their joint decision on relief, after which the debtor undertakes a series of bilateral renegotiations of each loan with each creditor following the guidelines of the Club's 'Agreed Minute'. The process has a high cost in administrative time of debtor country governments for each rescheduling, especially under the 'short leash' approach extensively used in the 1980s and 1990s which required numerous return visits to the Club to restructure each subsequent year or two of debt-servicing obligations. The point of the 'short leash' was (and is) political: to add to the pressure on the debtor government to

make the policy changes that the IFIs demand as a condition for disbursement of the various tranches of their loans.

The years of sequential rescheduling also meant long periods of debt overhang for these countries. At the same time and from its early years, the Club consistently accorded more debtor friendly terms to politically important cases. International opposition to how the Club operated and to the modest terms of relief built and built, until the Group of 7 major industrialized countries, which informally controls the Paris Club, gradually began to deepen the relief the Club gave to poor countries. Cosío-Pascal traces how the Club then became a pillar of the HIPC Initiative for the poorest countries and how it sought through the 'Evian Approach'—but apparently failed—to regain the initiative to be the key creditor forum for non-HIPCs. The Club remains, nevertheless, the institution that debtor governments must come to if they need a restructuring of their obligations to the major government creditors.

Cosío-Pascal concludes his analysis with three proposals for how the Paris Club could carry out its debt-restructuring tasks in a more balanced and comprehensive way. First, as the Club demands that the debtors seek 'comparability of treatment' from their private creditors, it should symmetrically accord 'reverse comparability' of treatment if the private creditors settle first. This could bring pressure for greater relief more quickly from official creditors, who otherwise tend to drag out the relief process. Second, he suggests that Paris Club member governments meet as consultative groups for individual countries (as had been arranged historically for Turkey, Indonesia, and certain others) to explicitly work out how much of international cash-flow support should be provided as rescheduling of debt and how much as 'new money'. This approach would also signal creditor confidence in the post-restructuring arrangement, and would reduce the chances that recovery programs would be under-funded. Third, he calls on the Paris Club to revive the 'bisque clause', which had been part of the Anglo-American lend-lease restructuring in 1956 (and has certain other precedents), wherein the debtor on its own initiative would be allowed to postpone rescheduled debt repayments in the event of an economic shock. This would help the debtor avoid shock-induced return trips to the Paris Club.

Matthew Martin takes us through the revealing case in point of how Ethiopia's debt burden was lifted. He traces the laborious process that the government underwent in eight separate debt renegotiation rounds in the Club from 1992 to 2004, four of them before the HIPC Initiative was launched and four as part of the Initiative. The final decision on HIPC relief for Ethiopia was then followed by a further reduction in debt under the MDRI, which canceled almost all of Ethiopia's remaining external debt.

Within the context of the donors' slow recognition of the need for deeper relief, Martin emphasizes how important it was that the Ethiopian debt management team gained the capacity and confidence to independently make its own debt sustainability assessments. Ethiopia thus became better able to

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advocate for itself in negotiations in the Bretton Woods institutions and with its government creditors on how much relief it required. Negotiations took place within the 'debt sustainability framework' that had been jointly established by the World Bank and IMF, which preset the definitions, the variables considered relevant, and the targets within which the sustainability assessments had to be made. Martin describes how Ethiopia successfully made the case for additional concessions under this complex process, winning, for example, additional 'topping-up' relief at the HIPC completion point owing to lower-than-programmed export earnings.

In the end, however, negotiation within the HIPC framework became moot. Decisions on relief based on achieving debt 'sustainability' were superseded by the MDRI aim to free up budget resources from debt servicing (complemented by substantial additional official development assistance) so as to boost government social expenditures to help reach the MDGs. This was political. As Northover explains, it was in response to pressure from international civil society campaigns that burgeoned in the 1990s. Drawing on moral and religious roots, these campaigns gave central place to the 'human development approach' in their policy thinking.

Northover emphasizes that there had been a struggle to change creditor government thinking. Despite the HIPC Initiative being a response to popular pressure, the creditor community put human development concerns into a separate box when it required HIPCs to formulate—in cooperation with the World Bank—'Poverty Reduction Strategy Papers' (PRSPs). The goal of debt relief itself was couched in terms of reducing HIPC debt as much as needed until the remaining obligations were 'sustainable' in the sense of being within the capacity of the debtor government to pay over time without significant economic and financial adjustment. Many civil society advocates rejected this approach as still privileging creditor interests, underscoring that essential anti-poverty expenditures would be sacrificed to debt servicing. They developed an alternative in which, first, reasonable targets were estimated for debtor-government domestic revenue; second, essential anti-poverty expenditures (and the costs of necessary normal government operations) were subtracted; and third, the remaining amounts, if any, could be used for debt servicing (or, if negative, indicated the additional aid requirements).

Whether this specific analysis was technically robust or not, politicians got the point of the continued public pressure and the terms of the international policy debate changed. Increasingly, it focused on donor commitments to help developing countries achieve the MDGs. The anti-poverty campaigns had tied debt relief firmly to reducing poverty, which had become a major driver of official development assistance. Debt relief thus became a variation on donor budget support for targeted expenditure categories. As debt campaigners argued, human development was a condition of 'debt sustainability'. This confluence of debt relief and aid goals became official international policy in 2005,

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when the MDRI canceled almost 100 percent of the debt owed by HIPCs to the international financial institutions (strictly speaking, 100 percent up to a cut-off date).

Northover further underlines how southern civil society organizations followed up on campaigning for debt relief by advocating and monitoring that the released funds were in fact spent on programs for the poor. This could be contrasted with the top-down approach of donor governments and the Bretton Woods institutions in their PRSPs and the 'aid effectiveness agenda'. Civil society organizations complained, for example that the so-called donor push for developing country aid 'ownership' emphasizes accountability of the recipient government to the donor governments rather than to its own stakeholders. Northover thus recommends that people responsible for the aid partnership process examine and learn from the experiences in the debt campaigns, so as to lead to genuine ownership which would raise the prospects for poverty reduction.

Politics and proposals in institutional reform

Our review of the history of debt crises has emphasized that the governments of many poor and emerging economies have had to sustain a decade or more of debt 'workouts', whether with private or official creditors, and quite a few countries ultimately had to disappoint their creditors who kept lending, often in increasing amounts, right up to the crisis moment when conditions made it impossible to continue servicing excessive debts. We argued earlier that part of the reason for this scenario is the absence of an effective sovereign insolvency system, one that would discourage excessive borrowing and lending and that would provide an effective and fair workout. We now turn to chapters that explore efforts to improve the sovereign insolvency process, and the political economy behind why some proposals have failed and others have been implemented, while additional proposals continue to be tabled.

We begin with Brad Setser's examination in Chapter 12 of the IMF effort to create the sovereign debt restructuring mechanism (SDRM) and the forces that lined up in favor and against the proposal. Anna Gelpern and Mitu Gulati then report in Chapter 13 on their research into how the once controversial 'collective action clauses' (CACs) became the new 'boilerplate' (fine print) in sovereign bond contracts. In their view, it was much ado about not much substantively, albeit of some significance politically. Barry Herman turns our attention in Chapter 14 to a reform initiative driven by the private financial community in the form of a voluntary code of good conduct that would informally pressure the debtor countries to follow policies and practices that the creditors advocate. Although implementation of the code is now monitored by a group of prominent individuals from the private and public sectors convoked by an

international bankers' organization, it is not clear that it will play a role in any wave of sovereign insolvencies. After all, and unlike a bankruptcy regime, it is purely voluntary. Herman suggests, instead, how to develop an alternative that would have greater credibility with debtors as well as creditors and could have some force behind it.

Two additional chapters extend our coverage of policy reforms to proposals that have been tabled but not yet acted upon. Jürgen Kaiser compares six proposals of civil society, financial sector, or academic parentage in Chapter 15, after which Patrick Bolton and David Skeel ask whether a reformed IMF could play a central role in a particular model that they have developed of sovereign bankruptcy. The proposals for reforming the workouts from defaults on private creditors were not subject to the same degree of political campaigning as the HIPC Initiative and MDRI. Rather, powerful financial interests campaigned heavily against reform. Indeed, the discussion about whether some new mechanism ought to organize sovereign debt restructurings when most of the creditors were holders of sovereign bonds was largely academic until November 2001 when the IMF proposed the creation of the SDRM. The IMF then began intensive development work on the proposal, but by April 2003 the proposal was dead.

Brad Setser gives a perspective on what happened and why. He emphasizes that different stakeholders had rather different ideas of what was wrong and how to fix it. He saw the mainly European creditor governments that supported developing the SDRM as wishing to give debtor countries greater legal protection against their creditors during debt restructuring, thereby reducing the demand for IMF bailout packages (although Setser finds little connection between the short-term financial crisis factors that lead to bailouts and the later process for restructuring sovereign bonds). Conversely, emerging economy governments that issue bonds internationally worried that they would in fact lose access to IMF funding in the event of need and they worried what signal the market might read from the creation of a bankruptcy regime, possibly raising the perceived riskiness and thus interest cost of their obligations.

International investors and financial market operators wondered where the problem was, as bonds were being restructured when needed and no litigation had interfered yet with any bond restructuring (the famous Elliot case had involved Peruvian bank debt left over from its Brady deal). If anything, the 'buy side' of the private sector wanted to further restrict the ability of a debtor government to protect itself from legal actions by its bondholders during a default. Civil society debt campaigners held a diametrically opposed view, calling for a sovereign bankruptcy regime to reduce the perceived pro-creditor bias in debt workouts. The debt campaigners also opposed having the IMF at the center of any sovereign bankruptcy regime, seeing it as pro-creditor, while the private creditors opposed such a role for the IMF for exactly the opposite reason, fearing it favored the debtor government.

According to Setser, the main intention of the IMF itself was to facilitate reaching collective debt-restructuring decisions without obstruction by hold-out creditors and litigators. The Fund was also seeking orderly debt reduction as an additional policy tool, so as not to be trapped into continued lending to insolvent countries. Different academic authors gave support to different sides, some favoring the status quo in order that fear of 'disorderly' restructurings would discourage over-borrowing (moral hazard), and others sympathetic to creation of a new approach for a more efficient and fair restructuring and a 'fresh start' for the debtor country (as proposed by Stiglitz in this volume).

As Setser sees it, the nature of the interplay among the stakeholders doomed the project. Major emerging country bond issuers and important parts of the US government—important because the United States is where most external sovereign bonds are issued—opposed the SDRM. Indeed, he argues (and Gelpern and Gulati in the chapter summarized below provide supporting evidence) that the SDRM proposal was largely developed as a result of a lack of communication among senior US government officials. The US and emerging market government opponents were also lobbied intensively by organizations representing the private creditors. The European supporters of SDRM had inconsistent goals: while backing a plan that would have put the IMF at the center of the bankruptcy regime, they were also seeking to trim the IMF's financial power in order to curtail bailouts. Moreover, all the main players—the private creditors, some of the major creditor governments, and civil society debt campaigners—distrusted the IMF, whose staff designed and refined the proposal behind closed doors in Washington, without sufficiently engaging country authorities.

Setser also points to certain inherent difficulties in the concept that would have had to be overcome for any SDRM design to be accepted. One involved the notion of sovereignty, which a comprehensive reform might seem to compromise. Another is that an orderly crisis workout is not necessarily the same as an orderly legal procedure for a workout (as he says, one might accept being subject to litigation as a price of deeper debt reduction). Third, as is known from corporate bankruptcy, the authority playing the role of the judge needs to be independent and have power to move the parties to a solution, while the standing of the IMF had been seriously eroded in the view of all stakeholders (let alone that it is itself a creditor), and has limited (but not zero) power over the sovereign debtor and none over the creditors.

At the same time that the SDRM was being considered, senior officials of the major creditor governments were also advocating a change in the standard clauses of sovereign bond contracts, particularly those issued under New York law. Anna Gelpern and Mitu Gulati found this intriguing, as it is doubtful that senior political figures in the major economic powers knew what legal boilerplate was, let alone would advocate for particular clauses. There was policy content in the advocacy, however, over whether 'market-based' (i.e., contractual) changes would suffice to provide for orderly restructuring of sovereign

bonds of developing countries in financial crisis. In fact, the CACs in question have yet to face a major test under fire. Gelpern and Gulati found little indication of belief among the more than 100 intimately involved people in the CAC debate that they interviewed that the clauses would be important determinants of restructuring outcomes.

The clauses in question sought to facilitate orderly debt restructuring by discouraging bondholders from individually suing debtor countries to fully recover their investments and thereby possibly disrupt negotiations between the debtor and a representative body of the bondholders, and by providing a structure for the collective decision on the precise restructuring terms. Most focus has been on the latter question, as New York (and German) law bonds had required unanimous bondholder agreement to change the financial terms of a bond. In fact, the unanimity clause in New York law bonds had not been a barrier to bond restructuring, as it was possible to organize a majority of bondholders to approve a swap into new bonds and at the same time severely weaken the legal claims of holdout bondholders who chose not to participate in the swap by voting to change non-financial terms of the old bonds that required only approval by a specified majority, a strategy called 'exit consents'.[14]

Gelpern and Gulati found that, instead of seeing the clauses as the path to orderly workouts of defaulted bonds, most of their interviewees saw them as part of a strategy to kill the SDRM. The CACs had originally been proposed after the Mexican *tesobono* crisis of 1994–5. When the central bankers of the Group of Ten (G10) major countries drafted them in 1996, it was to make bond restructuring easier and thereby reduce the need for huge bailouts, such as Mexico had received. However, there was no takeup of the proposal until after 2001, when they came to be seen as an alternative to the SDRM. While there was considerable financial industry and emerging market government opposition to both proposals, the antipathy to SDRM was very strong, including in many parts of the US government. CACs thus became the 'acceptable' (or harmless) alternative. As the authors say, 'market-based change came courtesy of successive Washington invasions', the first being in the late 1990s after the G10 report (and a subsequent report by a mixed north–south 'Group of 22' in 1998). The second wave made CACs into the new boilerplate. The SDRM threat and the strong personal advocacy for CACs from within the US Treasury by John Taylor, Under Secretary for International Affairs, carried the day.

Still, the essential point is that the clauses were not expected to matter, except perhaps at the margins, for several reasons. First, even before the CACs were adopted into New York law bonds, Ecuador's bond restructuring in 2000 showed how 'exit consents' could disarm a recalcitrant minority of bondholders even when unanimous consent was required to change the financial terms of New York law bonds.[15] Second, the market understood the Ecuador case to reflect explicit multilateral support for restructuring instead of bondholder bailouts. Thus, the CACs did not represent a new weakening of

bondholder claims. Indeed, by voluntarily introducing them in early 2003 ahead of the market and with no adverse effect on its borrowing terms, Mexico turned CACs into a signal of strength and quieted market fears that sovereigns would more readily default on their bonds (Mexico's reputation had become by then very strong). It also pre-empted the SDRM, which Mexico strongly opposed. Finally, as the authors conclude, the process of designing, refining, and implementing CACs signaled that the US government was removing itself from the contingent claim—and therefore from the implicit contract—for a bailout when sovereigns default.

Complementing their CAC offensive, organizations representing financial market lenders to the emerging economies sought to develop a voluntary approach to debt workouts. The aim was to bring informal groupings of private creditor representatives together with the debtor government to develop an exit from debt distress. Barry Herman traces the considerable ferment in the first half of this decade among emerging market finance professionals to develop this approach, to be embodied in a code of good conduct to guide relations between the sovereign debtor and its creditors. Although there is more than a decade-long history to the code, its momentum in the financial community in more recent years was probably a response to the SDRM proposal, on the one hand, and Argentina's unilateral approach to its creditors, on the other. In 2004, a subgroup of the drafters on the private sector side and representatives of four middle-income countries (Brazil, Republic of Korea, Mexico, and Turkey; notably not Argentina) adopted a draft of the code. The international community welcomed it as a work in progress, but the text of the code has not been revised or revisited since. Meanwhile, the Institute of International Finance, a major international banking organization, has been promoting the code, formally called the Principles for Stable Capital Flows and Fair Debt Restructuring.

Even though representatives of the 'buy side' (bond investors) dropped out of the discussions before the code was adopted, because they saw it as not friendly enough to their interests, Herman finds the code biased towards creditors. He nevertheless sees several positive features in it, although the negative ones prompt him to call for a more inclusive international process to produce a more balanced code. The positive features are primarily those that pertain to relations between the government borrower and its creditors during normal economic times. The code calls for transparency by the government and open dialogue with its creditors, as through an 'investor relations program' (IRP). This much is welcomed, especially if all stakeholders have access to the information made available to the creditors. The drafters appear to have thought that in times of debt crisis, the IRP could become the basis for a creditors' committee that could spearhead debt renegotiations with the debtor. Also, before default became unavoidable, the IRP could lead, in principle, to commitments by foreign banks and other financial institutions to maintain short-term credit lines and thus not provoke a currency crisis (at least not one they

themselves would lead). In effect, the drafters were suggesting that the government would wish to follow the policy reform proposals of the creditors to bolster their confidence that their monies were not being wasted. There are many additional details in the code, which Herman reviews, but one may see this as what it is, promotion of behaviors the creditors would like to see on the part of their sovereign borrowers.

Beyond concerns about the specific content of the code, Herman is critical that the code has no teeth. It is purely voluntary (the text of the code even begins with a disclaimer that no party is bound by it). Herman thus proposes not only an international discussion process to rewrite the code in a more balanced way, but also adopting a feature of IMF policy so as to promote enforcement of the code by both sides of a debt negotiation. The feature is the Fund's policy of 'lending into arrears' (i.e., to countries in default to their creditors), which the Fund will apply on condition that the country is making a 'good faith' effort to resolve its debt problem cooperatively.

The revised code, in Herman's proposal, would serve to spell out what 'good faith' means, both for the debtor and its creditors. A reformed IMF Executive Board would be responsible for assessing whether good faith efforts were being made by both sides. A negative finding could deprive the country of IMF funding and further reduce the market value of the non-performing bonds, creating a mutual interest in acting in good faith. A positive finding would continue IMF and other official creditor support of the country, but also signal this to the courts of the countries whose laws govern the bonds in default. If non-cooperating creditors (the proverbial 'vulture funds') sought to recover their assets through these courts, which would disrupt the negotiations of the cooperating creditors, the governments could make clear to their courts their preference not to find for the plaintiffs (something of this sort happened in the United States during the Argentine crisis). In short, while not a full bankruptcy regime, Herman is proposing that pressure could be put on the creditors and debtor to work cooperatively toward a solution as defined in a new code. As the debt workout process would have political legitimacy, not to mention formal endorsement by governments and international institutions, he believes it could in fact lead to orderly, effective, and fair debt workouts.

There have been a number of other ideas on how to skin this cat. Jürgen Kaiser, in Chapter 15, compares six proposals that have been discussed in different international forums (official, civil society, or private sector) as part of the effort to conceive a better approach to sovereign debt restructuring. He saw each of the six proposals as an attempt to break with the conventional way that sovereign debtors and their creditors interact. One of the proposals is the SDRM discussed above. None of the other proposals has gathered anything near the international political momentum behind them that the SDRM did before it was killed. However, no ideas should be discarded prematurely. Kaiser concludes that meaningful reform requires a political space in which to develop it;

i.e., it requires active engagement of debtor country governments in a non-creditor-dominated international policy forum that would seek to establish an impartial debt workout framework.

The five proposals besides the SDRM that Kaiser reviews include: Christoph Paulus's call for an international model law for sovereign bankruptcy that individual governments would adopt to govern how they would treat their creditors in a crisis; Richard Gitlin's call for a Sovereign Debt Forum to develop an agreed set of 'best practices' for negotiations and create an institutional capacity to facilitate such negotiations through mediation and informal adjudication; mediation, more generally, as used in other areas of dispute resolution; the Fair and Transparent Arbitration Process comprising independent ad hoc arbitration panels, as proposed by a number of northern NGOs; and the proposal of groups of southern NGOs and academic authors for an international insolvency arbitration court.

The proposals are compared in terms of five suggested targets of reform: effectiveness in restoring debt sustainability (i.e., debt restructuring adequate to reduce the risk of future insolvency); providing repayment security to new lenders (not the same as sustainability, as it can mean senior repayment priority for new lenders, as is the case for post-'cut-off-date' loans under Paris Club treatments); ensuring fair burden sharing between the debtor and its creditors and among the creditors (defining 'fair' in some mutually agreeable way, which may exclude 'odious' debt from repayment); minimizing avoidable losses to creditors and investors (which could depend on addressing a crisis in an orderly way as it first emerges); and establishing a reliable framework for use in future crises (reducing uncertainty for debtors and creditors on how they will be handled in a crisis).

The proposals that Kaiser discusses are attempts to go beyond the existing debt workout mechanisms so as to better address the inherent shortcoming in purely market-based solutions, which Joseph Stiglitz outlined in Chapter 2. Indeed, Stiglitz concluded his analysis with a proposal that has similarities to several of the proposals reviewed in Kaiser's chapter. Stiglitz's framework stipulates the following: the debtor government would initiate bankruptcy; this would suspend creditor litigation against the government; any new lending during bankruptcy would be privileged; the country could adopt policies to stop or discourage capital flight; the debtor would propose a workout to which the creditors could counter propose; assessments would be made of the economic and social impact of proposed workouts; and some sovereign bankruptcy authority would then rule, giving deference to the proposal of the sovereign. Acknowledging that his proposal is far from actionable at this time, Stiglitz further proposed three interim measures: that capital controls be considered during sovereign debt crises; that jurisdictional disputes over the governing law in sovereign bankruptcies be avoided through mutual recognition; and that an

international mediation service be created to help crisis governments and their creditors come to an agreed workout.

Finally, Patrick Bolton and David Skeel suggest investigating a new bankruptcy approach for resolving sovereign debt crises. While they have presented some of the basic ideas in other papers, the innovation they introduce here is to put the IMF at its center.

One key to the proposal is that instead of the IMF lending only its own funds to the distressed sovereign, which it can no longer do in amounts sufficient to counter international financial market panics, it would also be empowered to authorize private creditors to extend new credits that would have higher repayment priority than already outstanding debt, as is done in corporate bankruptcy cases. They envisage that amounts of such credit above some modest level would have to be approved by the defaulted creditors and that contributing private creditors would also need to be brought into the negotiations over the rescue package. The authors argue this approach would avoid some moral hazard problems as the loans would not be automatic: the new private creditors would still have to have sufficient confidence in the policy team of the regime to which they were lending to extend the credit. Also, at least some of the existing creditors would likely want to participate in this sovereign variant of corporate bankruptcy 'debtor-in-possession' (DIP) financing, as the new loans (at least in pre-default cases) would probably largely roll over the creditors' maturing or short-term outstanding loans, which would thereby raise their priority in the repayment queue.

One reason the authors would involve the IMF is that they think a purely contractual approach is unworkable, a specific case of a general point made earlier by Stiglitz. While it would be possible to make absolute priority for repayment part of, say, a post-default bond contract, it would be unappealing to the creditors because they would have to closely monitor the debtor; i.e., even if a bond contract placed the holder first in priority for repayment, the debtor could issue an additional bond that did not explicitly subordinate repayment to the first creditor. Each lender's repayment rights would be covered only by its own contract. This is why in corporate bankruptcy, the courts, not the lending contracts, determine the post-default priority for repayment. Thus, the IMF would be empowered to act like a bankruptcy court and assign repayment priority in sovereign debt crises. The authors leave open how the IMF would formally be empowered to assign repayment priority, but suggest that it could just do it in addressing the next crisis, implicitly suggesting that the courts through which unhappy creditors might seek to recover their claims through litigation might defer to the IMF, at least so long as the debtor appeared to be cooperating in good faith, as discussed in Herman's chapter.

A sovereign bankruptcy court also would have the advantage that it could manage the process with carrots and sticks so neither side stalls the move to a settlement. Absent that, the authors offer a two-stage voting procedure that

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would provide settlement incentives; i.e., first all covered classes of creditors would vote together on an overall 'haircut' percentage, and if that passed the debtor would propose a restructuring plan containing the treatment of each creditor class that together produced that haircut. Bolton and Skeel propose that in addition to the first priority accorded to DIP financing, creditors would be assigned seniority for repayment according to how long ago a loan was made. Then, if the debtor's restructuring plan were rejected, the claims would be reduced until the overall haircut was reached, with the lowest priority creditors suffering first, moving up the seniority scale, protecting repayment of the concerted interim financing as the highest priority of all (this approach also would deter those final spurts of borrowing at unusually high interest rates in the run up to a crisis by subordinating debt issued just before default). This assured fallback allocation of the haircut would function like the 'cramdown' in corporate bankruptcy.

The central point in the Bolton and Skeel proposal, as in Herman's, is that one may conceive of mechanisms for sovereigns, whether or not involving the IMF, which would mimic settlement incentives in corporate bankruptcy, without actually creating an explicit international bankruptcy law for sovereigns.

Towards a comprehensive sovereign bankruptcy regime

It has been the burden of this book to demonstrate that an important piece of the international financial architecture is missing and that its absence has been felt in protracted and economically painful workouts from sovereign insolvencies. As the sovereign debt workout processes are political at their core, they tend to benefit the powerful at the expense of the powerless. We also emphasize that principles for effective and fair bankruptcy systems for private entities if applied to the sovereign case could better balance the costs and pains of government insolvencies, except that the very nature of sovereignty precludes their direct application. But while there is no global government to enforce any sovereign bankruptcy law, there are various ways that governments can cooperatively formulate and operate a sovereign bankruptcy regime. The concluding chapter of our book suggests two modalities by which such a system might operate.

We are aware, nevertheless, that several different initiatives over the past 100 years to create such an international government insolvency mechanism have not borne fruit. We do not infer from this that it cannot be done, but that the successful reformers will need to better allay the hesitancies of the prospective beneficiaries and neutralize the opponents, particularly creditor interests, who stand to lose the privileged position they enjoy in the existing arrangements. The world is not static. Perceptions can evolve in the face of experiences. Reforms that were unthinkable at one moment can enter the realm of the politically doable at another. Our aim in preparing this book has been to help modify those perceptions. In truth, the reforms are warranted. As this book goes

to press, more and more countries are facing financial strains, and the lack of an international framework for dealing with sovereign insolvency could mean that, once again, the international community uses bailouts as a solution to debt crises, only because no viable mechanism to restructure the debt exists. Actions on reforms would clearly be timely.

Notes

1. While the IMF study focused on total public debt relative to gross domestic output, it noted that no more than seven countries were judged to be in debt distress in terms of the ratio of debt service to exports, which suggests that most defaults on debt of these countries were not judged to be imminent.
2. For example, the Jubilee Debt Campaign in issuing 'a wake-up call to anyone who thinks the developing world debt crisis has been resolved' focused on three very different country cases, emphasizing the scope of its concern: Zambia, the Philippines, and Bangladesh. Zambia had exited the HIPC program in 2005, the Philippines last renegotiated its debt to foreign banks and governments in the early 1990s, and Bangladesh has never had to work out of a debt crisis (Jubilee Debt Campaign, 2009: 4).
3. In other words, occupation of foreign territories to recover debts is considered unacceptable today, according to international law (see n. 7 below).
4. One indication of the degree of popular mobilization is that just before the United Nations Millennium Summit, Jubilee 2000 presented to the UN Secretary General a petition signed by 24 million people from 166 countries (based on data of the Jubilee 2000 Coalition).
5. A dramatic case in point is that of Argentina, where 45% of the population fell below the poverty line in 2002, the year after the debt default, roughly twice the percentage in 1990. Also, 19% of the population was classified as 'indigent' in 2002, compared to 5% in 1990 (United Nations, 2006).
6. It was called for in the 'Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts', adopted at The Hague in 1907 as part of a set of conventions on the laws of war.
7. Perhaps the two most famous cases are the French intervention (supported by Spain and Great Britain) in Mexico in 1863, installing Austrian Archduke Ferdinand as Emperor of Mexico (overthrown by the Mexicans and executed in 1867), and the joint German, British, and Italian blockade of Venezuela's ports in 1902–3. Other cases led to European colonial expansion, as in Morocco and Tunisia. In the Americas and in light of the Venezuelan blockade, in 1904 the United States under President Theodore Roosevelt announced the 'Roosevelt Corollary' to the Monroe Doctrine of 1823, essentially giving itself police powers over sovereign debtors in the region. Following a series of interventions, the policy formally ended with the adoption of the 'Good Neighbor Policy' of Franklin Delano Roosevelt in the 1930s.
8. For a report on that meeting, see Herman, 2004.
9. In addition to the papers published as chapters in this book, a number of papers written for this project could not be included but have been made available as working papers

at the project's website (http://www0.gsb.columbia.edu/ipd/programs/program.cfm?ptid=2&prid=15&tyid=itemtype&iyid=13). They include Iwan Azis, 'Fiscal Policy and Workouts from Debt Crises: The Case of Indonesia's Domestic Debt' (April 2008); Barry Herman, 'Dealing Deftly with Sovereign Debt Difficulties' (August 2004); Matthew Martin, 'Debt Sustainability: Relief Target, Rule for Lending or Policy Goal for Low-Income Countries?' (December 2007); Shari Spiegel, 'Sovereign Bankruptcy: Notes on Debtor Incentives to Repay Debt' (March 2002); and Joseph Stiglitz, 'Some Comments on IMF Paper on Restructuring Sovereign Debt' (March 2002).

10. See Stiglitz et al., 2006, for a discussion of alternative macroeconomic policy frameworks.
11. This is not to say that market enthusiasm is permanent, as Russia was subject to significant financial outflows in 2008 and 2009.
12. In fact, one of the foreign funds that invested in Russia and went bankrupt at the time of the Russian crisis is believed to have assumed that the probability of domestic default was basically zero. As rates rose, the model on which they based their investment strategy told them to keep buying more debt since default was virtually impossible. When the default finally occurred, the net asset value of the fund fell close to zero.
13. Although some bondholders had been awarded settlements in foreign courts, Argentina did not honor them. It also did not re-enter the international bond market, where new funds raised might have been attached by defaulted creditors. However, in September 2008, Argentina began an initiative toward settling the outstanding bonds, with proposals and counterproposals to and by various creditor groups, extending into March 2009 (see, for example, *Herald Tribune*, September 30, 2008, *Clarin* (Buenos Aires), March 2, 2009, and *Financial Times*, March 18, 2009).
14. The bonds might require only a simple majority or two thirds or three quarters of the votes of bonds to drop the sovereign's waiver of immunity or submission to the jurisdiction of a foreign court or change other clauses (see Buchheit and Gulati, 2000). The majority needed to adopt the exit consents thus became the majority needed to make the bond swap effective.
15. Ecuador's exit consents eliminated the cross-default clause (default on the old bond could not trigger default on other debt), provided that the swapped old bonds continued to exist legally (as 97% of bondholders accepted the swap, the government held 97% of the old bonds and so holdouts could not invoke measures that required, say, 25% of bondholders to enact), removed eligibility of the old bonds for debt–equity swaps or other privatization deals, and delisted them from the Luxembourg Stock Exchange, reducing whatever liquidity they might have had left (see Lindenbaum and Duran, 2000: 4).

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