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**The Political Economy of the SDRM**

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**Task Force on Debt Restructuring and Sovereign Bankruptcy**

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# THE POLITICAL ECONOMY OF THE SDRM

Brad Setser

The great surprise of the debate over the sovereign debt restructuring mechanism (SDRM) is not that the proposal of the International Monetary Fund (IMF) for international legal protection for bankrupt sovereigns failed. The Clinton Administration never came close to signing on to international legal protection for sovereign debtors, and George W. Bush will never be remembered for a stronger commitment to multilateral institutions than Bill Clinton. The surprise is that it the IMF was able to find the political space needed to put forward a proposal that generated a serious public debate on the need for sovereign bankruptcy.

The IMF's interest in providing sovereign debtors with formal protection from litigation predated the proposed SDRM. The IMF's top management in the late 1990s, Michel Camdessus and Stanley Fischer, had suggested that Article 8.2.b of the IMF's Articles of Agreement should be interpreted to give a sovereign protection from litigation. The IMF had quietly looked into a formal sovereign bankruptcy regime in 1995, {2} when Jeff Sachs caused a stir by publicly arguing for an international bankruptcy regime (Sachs 1995). Argentina's slow slide toward default in the fall of 2001 only reinforced the case for ambitious reform in the eyes of the IMF's new management team of Horst Köhler and Anne Krueger.

Sometimes the simplest explanation is also the best. US Treasury Secretary Paul O'Neill was a free thinker open to new approaches to old problems. He was not inclined to kow-tow to Wall Street traders slaving away in front of green computer screens – or to the rest of the Bush Administration. O'Neill's frustration with IMF bailouts of Argentina and Turkey led him to surprise the world, and his own staff, with his call for a new international sovereign bankruptcy law.

O'Neill's willingness to look for a fresh solution to old problems briefly led the US to drop its traditional veto on serious work on an international bankruptcy regime, and created the political space that allowed IMF staff to develop its blueprint. Yet O'Neill's isolation inside the Bush Administration made it impossible for him to ever close the deal. As we now know, O'Neill was out of step with the rest of the Bush Administration on a whole range of issues (Suskind 2004). Only six months after O'Neill surprised the world with his call for sovereign bankruptcy, {3} his own deputy for international affairs, John Taylor, made it clear that O'Neill had not brought the rest of the Treasury department along with him (Blustein 2002), let alone the broader Administration. Taylor's speech effectively signaled that no IMF design was ever going to win the support of the Bush Administration, {4} let alone the US Congress.

The IMF put forward a proposal that its architects knew was sure to be stillborn. Nonetheless, it is worth delving a bit deeper into the political economy of the debate over SDRM. Many of the constraints that shaped the IMF's final proposal reflect deep fissures in the international financial system, not the constraints unique to the Bush Administration.

- Different constituencies with a stake in the sovereign bankruptcy process had very different conceptions of what a sovereign bankruptcy regime should do. Groups who agreed on the need for an international bankruptcy regime in theory often had radically different visions of what sovereign bankruptcy should look like. This did not prevent the IMF from putting forward its own proposed design for an international bankruptcy regime. It did inhibit the emergence of widespread consensus around the IMF's proposal.
- The debate in the IMF executive board left many constituencies with a stake in emerging market debt, and thus in an international sovereign bankruptcy regime, with a sense that their concerns were represented only indirectly. These difficulties, interesting enough, were not the product of outdated voting weights that leave Europe over-represented and Asia under-represented on the IMF board. {5} Rather, they stemmed from the conflicting interests of many of the IMF's leading countries. The countries of the Group of 7 (G-7) had to choose between representing the interest of the private financial institutions inside their countries and their interest in limiting the need to commit public resources provided by the G-7's taxpayers to rescue troubled emerging economies. The major emerging economy borrowers were even more torn. They had to choose between defending their interest as borrowers seeking access to private capital in the markets, their interest in preserving their ability to borrow large sums from the IMF, and their interest in a better restructuring process.
- The difficulty finding a design for the SDRM that would match expectations and

The SDRM debate illustrates the profound difficulties building international consensus behind any sweeping change in global financial regulation. It also illustrates how public sector initiatives can influence private market outcomes even if they fail. The IMF's serious pursuit of an international bankruptcy regime clearly contributed to Mexico's decision to introduce collective action clauses. It pushed leading sovereign debt lawyers to develop more ambitious clauses that "aggregated" votes across several separate bonds, clauses which now have been incorporated into Argentina and Uruguay's international bonds. It also made it easier for some in the market to accept collective action clauses, which were viewed by many as preferable to the SDRM. The IMF's proposal thus helped to change the informal "norms" governing the sovereign debt market.

**Different Conceptions of Sovereign Bankruptcy**

A surprisingly wide range of people considers the absence of a sovereign bankruptcy regime to be a problem. Yet many who agree on the general need to change the existing sovereign workout process disagree on the precise problem that needs to be solved. Proponents of a new bankruptcy regime often have radically different conceptions of what a sovereign bankruptcy regime should do. The different views of key constituencies are worth exploring in a bit more detail – recognizing, of course, that any broad brush summary of the position of a diverse set of actors will gloss over certain nuances.

***IMF Creditor Countries***

Many of the IMF's creditor countries – those countries whose contribution to the IMF is available to be lent out to other countries – saw an international bankruptcy regime that would provide sovereigns with additional legal protection during a debt restructuring as an alternative to big IMF bailouts. They consequently saw sovereign bankruptcy primarily as a means to scale back large IMF rescue loans and to force the IMF to return to its traditional lending limits.

Some even interpreted opposition to the IMF's bankruptcy proposal as little more than an attempt by market participants to maintain a system that drew on public resources to bail out private interests. {6} That argument goes too far. Creditors with short-term claims coming due — not long-term bondholders – are the biggest direct beneficiaries of IMF bailouts. No doubt, individual bondholders can always sell their claims to another bondholder but that only shifts the claim from one creditor another. Countries only have to pay off their bonds in full out of their cash reserves when they come to maturity. No doubt, IMF lending – and expectations of IMF lending – can influence the market price of long-term claims. The announcement of a large IMF loan can increase the market value of long-term bonds, since the bailout can create expectations that the country will be able to overcome a cash crunch that could otherwise lead to a general default on long-term and short-term claims alike. However, bondholders tend to take large losses if an IMF bailout fails and the country enters into widespread default – as Argentina demonstrated. The clear winners from a bailout are short-term creditors who can get out quickly and those holding bonds maturing in the near-term. Bondholders who take advantage of a short-term rise in market prices after the announcement of an IMF loan to sell also win – but if the bailout doesn't work, the institution who buys their bonds may not. {7}

Indeed, the creditor countries' belief that bailouts stemmed largely from the absence of an international bankruptcy regime that facilitated an orderly restructuring of bonded debt was not well grounded. Three reasons suggest that bankruptcy and bailouts are not direct substitutes:

- Most bailouts have come in response to the roll-off of short-term claims, whether domestic sovereign debt, cross border bank lines or dollar-denominated domestic bank deposits, ***not*** long-term sovereign bonds. {8} Yet the IMF' proposed bankruptcy regime would only have covered long-term sovereign bonds.
- Paul O'Neill's argument that "with no clear process of sovereign debt restructuring in place, when a nation is on the brink of financial collapse, we have two stark and uninviting options – unwarranted lending or sending a nation off a cliff into a catastrophic default" {9} is false. Exchange offers, combined with the ability to amend a bond's terms (non-financial terms for New York law bonds issued prior to 2003, financial terms for English law bonds and New York law

- A bankruptcy regime that just eliminates the risk of litigation would not significantly reduce the economic disruption that typically follows a default. Effective legal action by creditors against a sovereign in default is extremely difficult even without formal bankruptcy protection. Conversely, formal bankruptcy protection would not magically allow countries in default to avoid runs on their currency and banking system. Nor would protection from litigation allow debtor countries to avoid running current account and budget surpluses after default. The need to adjust stems not from litigation, but from the loss of access to market financing.

### *Borrowing Countries*

Most of the countries that raised funds in the international bond market also saw themselves as potential borrowers from the IMF. The major emerging economies – and particularly the Latin American economies – feared losing access to large scale emergency credit from the IMF in return for legal protection of only marginal value. Mexico's Guillermo Ortiz memorably complained that the IMF was spending too much time building morgues to house the dead (countries that had to default), and not enough time trying to find ways to help the still living (countries struggling to avoid default).

{10}

Of course, default is part of most markets. Just as it is unrealistic for the IMF's creditor countries to think sovereign bankruptcy would avoid all bailouts, it is unrealistic for the major emerging economies to think that the IMF will prevent all default. The representatives of borrowing countries had to choose whether to represent their interest as debtors seeking to raise money on capital markets at the lowest possible cost and their interest as countries that might benefit from an efficient process for restructuring sovereign debt should they ever be forced to default. A bankruptcy regime that penalized default might well lower their cost of capital – but would also make it harder for debtor countries that ended up in default from getting a fresh start and moving on.

This tension was present in other contexts as well. Debtors worried that any legal change to standard New York law bond documentation – even a change that did nothing more than adopt documentation widely accepted in international bonds governed by English law – would be interpreted by the market as a signal that the country was unsure of its ability to pay on time and in full. They consequently worried – despite the absence of any supporting empirical evidence {11} – that introducing collective action clauses would raise their cost of borrowing.

Borrowing countries also were keen to protect their sovereignty, and to prevent an international organization from gaining jurisdiction over their domestic-law debt. If domestic debts had to be restructured, emerging economies preferred to have decision-making remain in their capitals – not in Washington, the presumed seat of the new international sovereign bankruptcy regime. {12}

### *Private Creditors*

Private creditors almost uniformly rejected the IMF's call for a bankruptcy regime, though opposition was stronger in the United States than elsewhere. Most believed the existing process worked reasonably well. Few creditors accepted the IMF's basic argument that "the emergence of bonded debt as the primary source of financing for emerging market sovereigns" has made the restructuring process "considerably less predictable" and made "creditor coordination problems … far more pronounced." {13} Creditors argued that existing bond restructurings had been carried out relatively quickly, that bond holders were more willing to recognize losses and move on than banks, in part because they "marked to market" and took losses immediately, and that participation rates in bond exchanges had been high.

Creditors had a point. Academic analysis of the potential collective action problems created by unanimity clauses in sovereign bonds were theoretically elegant, but lacked empirical support. {14} Holdout litigation had yet to impede a bond restructuring. {15} Among other things, academic analysis initially failed to recognize the premium most bond holders place on liquidity, and how this provided an incentive to join other creditors in a restructuring. Holdouts were sure to hold onto an illiquid claim that would be difficult to sell, yet the payoff from any litigation was uncertain. {16}

Rather than agitating for super-majority voting to address the creditor coordination problems identified by the IMF, many creditors argued the existing process already gave a sovereign in default too much legal protection. Consequently, leading creditor groups – most notably the Emerging Markets Creditors Association (EMCA) – pushed for legal changes that would increase private creditors' leverage over debtors in default. {17} Creditor proposals implicitly defined the problem in sovereign bond markets as the absence of any mechanism to shift "control" of the sovereign's operations to creditors – a process analogous to the transfer of control from equity investors to creditors holding the firm's debt in private bankruptcy.

Most private creditors recognized that the outright shift of control is implausible (Gelpern 2004). However, they argued that their weak existing legal hand allowed a sovereign that is already in default to remain in default for too long and to ignore demands for face to face negotiations with its creditors. Those complaints grew in force over time, as Argentina certainly showed no particular desire to rush to put an offer on the table. Private creditors also complained that sovereign debtors rejected calls to pay the expenses of a bondholders creditors' committee – a seemingly small demand that looms surprisingly large in the list of "rights" creditors wanted debtors in default to respect. In the 1980s, sovereign debtors had generally paid the expenses of a committee of leading bankers, and the expenses of creditor committees are also covered in private bankruptcy proceedings. {18}

Creditors' groups claimed to support the introduction of collective action clauses. But the actual clauses they proposed generally made it easier – not harder – for a creditor with a relatively small stake in an individual bond to hold out. It is quite easy to devise a bond whose financial terms can be amended (unlike traditional New York law bonds) yet is harder to restructure than a traditional New York law bond. For example, the ability to amend an individual bond's financial terms with the support of 90 or 95% of its creditors is effectively worthless. Sophisticated holdouts only litigate for significant sums – they need a big enough upside to justify their legal and other costs. A holdout would almost certainly be able to buy 5 or 10% of a bond and thus have a position that is immune from amendment. Conversely, creditors often sought to restrict the ability of a debtor to amend a bond's non-financial terms {19} and to reduce the protections now granted to a sovereign's reserves.

The creditors' agenda for improving the sovereign work out process tended to focus, not surprisingly, on strengthening "creditors' rights" against a sovereign – something creditors found lacking in the IMF's initial proposals. Yet many of the "creditor rights" proposals reflected a very particular conception of creditor rights – one that seemed focused on increasing the ability of an individual creditor to hold out and litigate rather than providing the creditor collective with additional rights against the sovereign.

Creditors – or least the most vocal creditors – seemed to believe that the threat of holdouts was necessary to convince perfidious debtors to put a fair offer on the table. They may have defined their interests too narrowly. The risk of making bonds too hard to restructure is that such language won't prevent sovereign defaults, but it will delay sovereign restructurings. If bonds are too difficult to restructure, a sovereign could well conclude that it would be better off staying in default until creditors cry uncle. Argentina, for example, preferred to wait than to do a deal on any but its own terms.

***Activists***

Civil society debt campaigners from churches and non-governmental organizations (NGOs) in the North and South generally put forward a different rationale for sovereign bankruptcy than the rationale put forward by the IMF's creditor countries. They argue that the absence of "bankruptcy" style protection for sovereigns shifts negotiating power toward creditors. Debtors therefore consistently offer creditors too generous terms and fail to get rid of their debt overhang.

"Debtor advocates" consequently argue that sovereign bankruptcy is needed to shift the balance toward debtors. They want a regime that puts lower priority on repaying old debt and a higher priority on providing debtors with a fresh start. Such a fresh start would allow resources that would otherwise go to debt-service to be redirected toward social and growth-enhancing expenditures. {20} Many propose the creation of a neutral third party that would – if negotiations drag on for too long – be able to judge how much debt relief the debtor needs, and then force creditors to accept the needed debt reduction. Most insist that the IMF could not serve as a neutral third party.

The NGO community generally did not want the IMF involved in determining a sovereign debtor's payments capacity. Rather, they wanted an independent arbitrator to determine a country's repayment capacity and to be able to impose deal terms on creditors consistent with that capacity. {21} Ironically, while creditors believe the IMF, as inter-governmental organization, systematically sides with debtor governments, most NGOs believe the IMF, as a financial institution, systematically sides with other creditors.

The assumption that the existing restructuring regime favors private creditors may not survive Argentina. After all, the government of Argentina sought – and received – much more debt relief than other recent sovereign debtors. Argentina entered into its crisis with more sovereign debt than most other emerging economies, particularly since its pre-crisis debt levels needed to be adjusted to take into account Argentina's heavy reliance on dollar debt and its overvalued currency. {22} But even in comparison with other heavily indebted counties, Argentina also has placed more emphasis on getting a "fresh start" from its creditors than on doing a deal that meets or exceeds creditor expectations.

***Academics***

Academic economists have put forward three different approaches to sovereign debt restructuring.

One group, building on work by Eaton and Gersovitz, {23} argues that procedures for addressing sovereign default need to be designed above all to create incentives for sovereigns to pay, not to help a sovereign that is unable to pay restructure efficiently. Andrei Schleifer argues that in the absence of perfect information about debtors' intention to pay, a bankruptcy regime that favors debtors ends up penalizing not creditors but those debtors who intend to pay. Creditors will charge more (and lend less) to everyone (Schleifer, 2003).

This group tended to favor the existing system of contracts, arguing that the threat of a disorderly workout is necessary to create ex ante incentives for sovereigns to pay – particularly since the sovereign is largely immune from direct legal sanction. Their position matched that of many market participants. However, Argentina's recent restructuring must give these academics pause: as noted above, the current non-system does not necessarily favor creditor interests. {24}

Another group puts more emphasis on the difficulties conducting an efficient and fair restructuring. In 1995, Jeffrey Sachs argued that both an international lender of last resort and an internationally sanctioned standstill on payments could avoid the inefficiencies created by a disorderly run on an illiquid sovereign (Sachs 1995). Joseph Stiglitz has noted that private parties bargaining over the outcome of debt restructuring will not generate efficient outcomes in the absence of perfect information. {25} He also has argued that efficiency should not be only concern: Bankruptcy regimes should be designed to create *fair* outcomes as well. Many working in this tradition argue that sovereign bankruptcy procedures should be designed both to help mitigate the pain associated with an unavoidable default and to assure that the restructuring leaves the country with a debt burden conducive to growth. In this way, these academics echo the NGO community's emphasis on "a fresh start."

This group typically argues some form of statutory approach is necessary, though not necessarily the approach put forward by the IMF. {26} This group recognizes that the choice of bankruptcy procedure will alter sovereign incentives to default or pay. But they do not conclude that this requires strong penalties to discourage countries from default. Most countries have tried to pay their debts; opportunistic default has been rare. Moreover, excessive penalties for bankruptcy can lead countries to postpone initiating a necessary debt restructuring. This can have severe costs. Countries may maintain excessively stringent fiscal and monetary policies. Or they draw on captive sources of financing – like the domestic banks – for the funds needed to avoid immediate default even if such actions weaken the country's financial health. Argentina is a case in point: it drew on the domestic banks' liquidity throughout 2001, leaving the banks in far worse shape to weather Argentina's ultimate default (Rosenberg, et. al. 2005).

Perhaps the most creative academic argument comes from Jeremy Bulow. (27) Bulow (2002) argues that sovereigns generally have incentives to borrow and spend too much, since the current government benefits from current spending, while future generations (and future governments) pay the cost of its borrowing. To discourage over-borrowing, Bulow consequently argued for a bankruptcy regime that favored debtors. This is a minority view, but it bears some resemblance to the arguments about "debt intolerance" put forward by Rogoff, Reinhart and Savastano (2003).

***IMF***

IMF staff and management put forward two arguments for a sovereign bankruptcy regime. First, the absence of an international bankruptcy regime created specific functional gaps in the international financial architecture. Second, a sovereign bankruptcy regime would change the political economy of the IMF – or perhaps the political economy of the IMF's leading members – and thus generate better IMF lending decisions.

*Filling in the gaps.* The IMF initially argued that a formal, statutory bankruptcy regime would fill in four identifiable gaps in the existing institutional arrangement for managing a sovereign debt restructuring. (Krueger 2001)

- There was no mechanism to prevent creditors from "disrupting negotiations" by seeking full payment – in other words, unlike, in domestic bankruptcy, there was no stay on enforcement.
- There was no mechanism to encourage the debtor to "act responsibly."
- There was no mechanism for providing "fresh new money" from private creditors. Specifically, there was no way to provide legal priority to new private money provided after a default – so private "DIP" (debtor-in-possession) financing was not possible in the sovereign context.
- There was no way to bind a minority of creditors to restructuring approved by a large majority of creditors.

Over time, the IMF focused most of its attention on one of those four gaps: the absence of super-majority voting on a debtor's restructuring proposal. {28} There was a good reason for this: There simply was not much empirical evidence that the other "gaps" posed much of a problem in practice, as opposed to theory (Roubini and Setser, 2004).

In particular, neither debtor nor creditor lawyers thought the absence of a formal stay was much of a problem. Sean Hagan (2005 at 312) notes:

> "For a variety of reasons, the assets of a sovereign that are available to a judgment creditor are rather limited. First, even if the debt agreement provides for a broad waiver of sovereign immunity with respect to the attachment of assets, the laws of the sovereign will generally prevent a judgment creditor from seizing assets of the sovereign located within the sovereign's territory. Second, not all assets located outside the sovereign's territory are available for attachment. … It has generally been understood that diplomatic property is protected, even if the waiver contained in the contract is very broad. … Most importantly, perhaps, the reserves of the central bank – a potentially attractive target for a judgment creditor – will normally not be available for attachment unless the central bank is also liable under the terms of the debt instrument."

Difficulties collecting on legal judgments against a sovereign {29} effectively provided a sovereign with a de facto stay while it developed its restructuring proposal, so long as it took reasonable precautions.  Hagan again: “it is clear that the ‘rush to the courthouse’ that provides one of justifications for an automatic stay under corporate rehabilitation laws does not exist in the sovereign context.” {30}

Senior new financing also fell by the way side.  Creating a legal mechanism to provide priority to new financing proved to be technically very difficult.  Priority payments in domestic bankruptcy can always be made by seizing control of the debtor and selling its assets; senior creditors have the first claim on these assets.   That is virtually impossible for a sovereign, so priority ultimately required giving senior creditors the right to go after payments to junior creditors.  Creating legal seniority therefore implied an agreement from existing bondholders to subordinate their claims to new money.  And at the end of the day even such a subordination agreement provided no protection against the most likely risk: that the sovereign would decide to stop payments on all external creditors, senior and junior creditors alike. {31}  It seemed to make more sense to continue to rely on existing mechanisms for providing senior new money: the IMF and the multilateral development banks.

In the end, the IMF’s case for the SDRM rested almost entirely on the need to allow a sovereign to restructure its international sovereign bonds through a single aggregated vote.  Such a vote would bind all creditors to a restructuring deal that had the support of a super-majority of bond-holders.   By curing the debtor’s default, it would also eliminate a sovereign debtor’s real point of legal vulnerability: the risk a creditor would hold on to their old bonds, reject an exchange, and then freeze payments on the new bonds. {32}

The IMF never envisioned letting a third party determine the amount of debt relief that was needed; {33} control over the process would have remained firmly in the hands of a debtor and its creditors. Anne Krueger stated this clearly when she first proposed a new bankruptcy regime in 2001:

> “The outcome in any given case will remain where it should be — in the hands of the debtor and creditors. Holdout creditors would be restrained in the event of an agreement, but it would remain for the bulk of the creditors to negotiate and ultimately decide whether to accept the terms on offer. The international community is not going to impose the terms of any restructuring agreement on debtors and creditors.”

The IMF’s final proposal consequently fell short of what many people had in mind when they heard the word bankruptcy. It covered just a fraction of all sovereign debts. In all probability, aggregated voting alone neither would shift bargaining leverage to the debtor nor give debtors more leverage over their creditors. {34} It consequently did not guarantee a debtor a fresh start. It certainly did not provide creditors with any new rights. It envisioned a restructuring process that would resembles the procedures for aggregated voting found in Uruguay’s new bonds far more than the court supervised restructuring of Chapter 11 of the US bankruptcy code.

*Changing the political economy of the IMF.* IMF staff put forward another argument for

SDRM: the presence of an international bankruptcy regime would lead to better IMF lending decisions.  It would change the political economy of the IMF – or more accurately, the political economy of the IMF's major shareholders, who call the shots on major lending decisions.  IMF management – and even more so IMF staff – was careful not to present the SDRM as an alternative to all IMF bailouts.  But it did argue that legal protection from holdouts would reduce the odds that the IMF would feel compelled to back "bad" bailouts.  {35}  Hagan (2005) notes,

> "It was recognized that it [the proposed SDRM] would make it easier for the IMF to resist pressure to provide financing to a member whose debt is judged to be unsustainable. By establishing a legal framework … that made the restructuring process more rapid, orderly and predictable – and therefore less costly – the assumption underlying the  SDRM proposal was that it would produce a credible alternative to continued financing, on the one hand, and an uncertain and potentially chaotic restructuring process, on the other."

This argument, unfortunately, understates the difficulties in avoiding "bad" IMF lending decisions.  The line between sustainable and unsustainable levels of debt is rarely clear cut.  The differences between Brazil and Argentina, and even between Turkey and Argentina are not so obvious that they lead immediately to the conclusion that, with an SDRM, the IMF would have bailed out Turkey and Brazil but not Argentina. {36}  If there had been an SDRM, the IMF might still have offered large bailout loans to Argentina, Turkey and Brazil – or it might have denied all three rescue packages.

The IMF's argument also implies that the IMF had no choice but to provide Argentina with financing to support the currency board and to avoid a coercive debt restructuring during the course of 2001 in the absence of an SDRM. That is not true: other options were available in Argentina even in the absence of an SDRM. {37} Similarly, the oft-made argument that supermajority voting would have allowed Argentina to restructure its debts without falling into default is a bit too optimistic. Creditors showed no signs of accepting the scale of debt relief that was needed prior to Argentina's default – Uruguay offered creditors relatively generous terms even after the sobering example of Argentina softened creditor opposition to a restructuring.

Finally, the SDRM would not have addressed the biggest political impediment to the resolution of Argentina's crisis: the unwillingness of the Argentine political class to exit from the currency board – yet such an exit was every bit as necessary as a bond restructuring. {38} Even with a better mechanism for restructuring international sovereign bonds in place, the transition from a currency board to floating exchange rate would have remained difficult. Argentine borrowers – firms and households alike – would not have been able to repay their domestic dollar loans and Argentina's banking system would still have lacked the dollar liquidity to honor its dollar deposits in the event of a run. International sovereign bonds held by external creditors were only one of many dollar denominated claims that needed restructuring – and in many ways <u>not</u> the most important. {39}

**The Debate Inside the IMF's Executive Board: Who Speaks for Whom?**

The IMF's general counsel, Sean Hagan (2005 at 301), has argued.

> "By the end of a period of intensive discussion regarding the design of the SDRM, a relatively detailed blueprint of the proposal had been endorsed by most Executive Directors of the IMF, evidencing broad support among member countries."

That is the best possible spin that can be put on the deliberations of the IMF's executive board. {40}

The relatively broad support for the SDRM reflected – more than anything else – Europe's over-representation on the IMF's Executive Board. Sharing sovereignty in the EU made most European countries more comfortable with supranational legal regimes than the US. {41} Moreover, French and Swiss and increasingly even German laws were increasingly irrelevant to the global sovereign debt market. Almost all international bonds are now governed by New York law, English law, and to a lesser extent Japanese law. France had little reason to worry about the prospect that the SDRM would override English or New York law. As importantly, most European countries believed, no matter how thin the evidence that an SDRM would help to "limit" IMF lending.

However, it is hard to impose new practices onto a market without support from the main issuers, the major creditors or the authorities of the jurisdiction whose law governs most issuance. Neither the world's biggest issuers of international sovereign bonds (Brazil, Mexico, Turkey) nor the world's most important legal jurisdiction for international sovereign bond issuance (the United States) ever came close to supporting the IMF's proposal.

Almost every constituency with a major stake in the design of a new bankruptcy regime was represented in the IMF's internal debate, but almost no constituency was represented directly. The concerns of private creditors in the US and Europe typically were <u>not</u> voiced by the US and European chairs on the IMF's board. Rather, the concerns of private creditors were expressed by emerging economies active in the international market. Emerging economies warned against any steps – including granting sovereign debtors bankruptcy protection – that might upset the international bond market and reduce the flow of funds to emerging economies. {42} Conversely, Germany, Switzerland, Sweden, Belgium, the Netherlands {43} consistently pressed for a bankruptcy regime that offered substantial legal protection for sovereign debtors, even if this meant making it harder for European investors in emerging market debt to initiate litigation against a bankrupt sovereign. {44} The other major European countries were less inclined to resist the IMF staff proposals to drop a formal stay on litigation, but they still tended to support the SDRM.

This system of indirect representation was not without its problems. Private creditors resented their exclusion from the fora making decisions on the IMF's proposal, and doubted that emerging market borrowers truly had their best interests at heart. Emerging market debtors were equally suspicious of the motives of the IMF's "creditor countries." They feared that the "creditor" countries wanted a bankruptcy regime so that the IMF could withdraw from the business of providing large loans to emerging economies, not because the creditor countries wanted to help emerging economies.

One important – but small – constituency lacked an obvious voice on the board – the "sovereign debt bar." Yet the set of lawyers who actually draft the legal language used in New York law bonds had plenty of informal opportunities to shape the IMF's proposal, since the IMF's legal department consulted extensively with lawyers in private practice. {45} However, the New York bar never really embraced the SDRM. Most firms that typically represented creditors did not think there was much need for a new bankruptcy regime to begin with. {46} And not one of the leading New York firms representing debtors spoke up in favor of the SDRM. Contracts are written by debtor and creditor lawyers in private practice in New York. Treaties, such as amendments to the IMF's Articles, are drafted in Washington.

Most constituencies with a direct stake in the sovereign debt market could agree on one thing: one particularly constituency – the IMF – had too large a role in the design of the SDRM. Suspicions about the role the IMF would play in a restructuring process designed by the IMF clearly made it more difficult to sell the IMF's proposal. {47} Yet the discussion over a proposed sovereign bankruptcy regime also would never have advanced as far as it did without the leadership of the IMF's top management, and technical competence and intellectual drive of IMF staff. Paul O'Neill supported "sovereign bankruptcy" in principle but the US Treasury certainly never put a concrete proposal on the table. The Treasury's intellectual energy was devoted to developing model clauses, not to working through the details of an actual sovereign bankruptcy proposal.

Moreover the IMF staff – prodded by the IMF's board's resistance to the staff's initial proposal – came up with a series of truly innovative ideas. After calls for a Chapter 11 style bankruptcy regime with a heavy IMF role generated at best tepid support, the IMF started to work on a stripped down proposal {48} that differed in important ways from previous blueprints for sovereign bankruptcy. {49} This effort was never truly recognized: given the looming US veto, it was hard to convince anyone to delve into the details of the IMF's final set of proposals.

However, the IMF proved far more adept at working through the technical details required to create a workable international bankruptcy regime than at building broad support behind the need to create an international bankruptcy proposal in the first place. The IMF's internal processes are designed around communication between the IMF staff and management and the IMF's board. Long board papers full of technical details tend to generate consensus to draft another long paper exploring yet more technical details, not deep agreement on what a bankruptcy regime should aim to do. The IMF's internal processes are well suited to hashing out the technical details of a design if there is already deep consensus on the need to change. But it is not well suited to building consensus on the need to change. Building consensus around the need for fundamental change requires communication with senior decision-makers in national capitals – decision makers who are unlikely to read long, technical papers.

The IMF in effect assumed that O'Neill's statements of support signaled that a broad consensus on the need for an international bankruptcy regime already existed, and that all that the IMF needed to do was to work out the technical details. If the technical problems could be solved, the "votes" on the board would be there. That, in retrospect, was clearly never the case.

**Trade Offs in Design**

The absence of agreement on what functions an international sovereign bankruptcy regime should perform meant that the technical debate over the IMF's proposed design never got elevated to the highest levels of decision making. Nonetheless many seemingly technical issues raised important general issues – issues that would need to be resolved should proposals for a formal sovereign bankruptcy regime be revived.

*The desire to protect sovereignty trades off with a comprehensive bankruptcy regime*

A truly comprehensive sovereign debt restructuring mechanism that covered all sovereign debt would require a significant surrender of state sovereignty. Right now, any investor challenging a domestic sovereign debt restructuring – even one done by decree rather than negotiation – has to do so in the sovereign's own courts. {50} Putting domestic debt in an international bankruptcy regime was a bridge too far for almost everyone. Hagan (2005 at 352) accurately noted:

> "A number of countries could not accept the possibility that debt issued within their own territories and subject to their own laws could be restructured under a legal framework that would be administered by an international dispute resolution body. Even among mature market countries – who were very unlikely to avail themselves of the SDRM to restructure their debt – there was likely to be a concern that the domestic legislature would be unwilling to adopt the SDRM if there was even the remotest possibility that it could be used to restructure domestic debt."

Moreover, shifting control of the restructuring of domestic debt to the international level would crimp a sovereign debtor's ability to set, within broad limits, its own priority system after a default. {51} Right now, sovereign borrowers have the de facto ability to give preference to domestic payments to try to reduce the – no doubt large – political and economic costs of default. {52} Argentina, for example, decided to pay bonds held in the domestic banking system (along with the IMF, the World Bank and the Inter-American Development Bank) while remaining in default on its other debts. Russia opted to default on its domestic debt and "Soviet-era" international debt while remaining current on its "Russian" international bonds. {53}

Even a narrow international bankruptcy regime that targeted international sovereign bonds would imply that the world's major financial centers – notably the US and the UK – give up jurisdiction over debt markets currently governed by their own national law. Sean Hagan (2005) notes: "No matter how streamlined the SDRM proposal became, its provisions would still interfere with the contractual claims of U.S. investors. Moreover, the jurisdiction of the DRF [Debt Resolution Forum], although limited, would supersede that of the U.S. courts during the restructuring process." {54}

*Can an orderly legal process produce an orderly debt restructuring – or are they different concepts?*

An orderly legal process is one where litigation – whether litigation prior to the restructuring proposal or litigation by holdouts after a widely accepted restructuring – does not interfere with the successful conclusion of the sovereign debt restructuring. An orderly sovereign debt restructuring is one where the restructuring itself does not lead to greater than necessary economic disruption, and a larger than necessary loss of output. Some disruption and losses are inevitable and theoretically, there has to be some cost of default just to discourage default; but practically, a country that defaults usually faces major consequences. It usually has to finance all foreign payments out of its current earnings, grants and reserves. That often requires adjusting fiscal policy along with shifts in the exchange rate and declines in economic activity sufficient to eliminate any current account deficit, and often to generate a balance of payments surplus to finance capital outflows. At the same time, a restructuring that provides the necessary debt relief without triggering a run on the banking system or the currency is likely to be much less costly than one that does. In sum, while restructurings need to be sufficiently costly to assure that debtors' have an incentive to honor their commitments, it is not obvious that generating incentives to pay requires contractions in economic output like those experienced in Argentina.

Legal protection for a sovereign going through a restructuring – and the capacity to approve a restructuring proposal by supermajority voting – may increase the odds of an orderly debt restructuring process. But the relationship is indirect. A restructuring proposal approved by supermajority voting may still result in substantial losses for the banking system (if the banks hold international bonds) and thus still trigger a run. A run on the banks – particularly a run on domestic currency deposits – typically turns into a run on the currency. Depositors pulling local currency – "pesos" – out of the banking system typically want dollars – or now perhaps euros – not another financial asset denominated in the local currency. A default may still be necessary to convince creditors to give the debtor the needed relief, even if the restructuring only needs to be approved by a supermajority.

Indeed, access to new funds – funds that can come from the IMF even in the absence of a new sovereign bankruptcy regime – may do more to generate an "orderly" debt restructuring than protection from litigation or super-majority voting. Foreign currency is often in short supply when a government defaults. Yet access to foreign currency reserves often remains vital, whether to help backstop the banking system or to support the value of the country's currency. {55} Look at what happened in Uruguay: access to IMF financing, combined with a government that decided to seek only modest relief from its creditors, created an orderly restructuring process even in the absence of an orderly legal procedure to carry out the restructuring.

One last point: the absence of litigation is not the only criterion creditors or debtors use to judge the success of the debt restructuring process. A debtor might conclude more litigation is an acceptable price to pay for more debt relief: Argentina, for example, seems to have made this choice. Creditors may prefer litigation if that leads the debtor to put a generous proposal on the table quickly (a big assumption). Of course, neither debtors nor creditors win if legal difficulties lead to a prolonged default that inhibits the debtor's economic recovery.

*Role of IMF: does the "judge" need to also be a "banker" to have leverage over a sovereign borrower?*

Private creditors, debtor advocates and most academics agreed on one point: the IMF was an interested party – a creditor – and it therefore should not have a role in the operation of an international bankruptcy regime. Domestic bankruptcy is overseen by a disinterested judge, and many understandably wanted a "disinterested party" to oversee the sovereign restructuring process. They objected strongly to the IMF's initial proposal, which seemed to modify the chapter 11 model in ways that provided a larger role for the Fund. {56}

However, an effective referee has to have leverage. The core source of leverage available to a judge in "chapter 11" and similar domestic bankruptcy proceedings is the judge's ability to end "reorganization" negotiations and start liquidation proceedings. Consequently, chapter 11 operates in the "shadow" of Chapter 7, the procedures for liquidating a failed firm. Sovereign liquidation is an impossibility, and a sovereign's management is accountable (one hopes) to its electorate, not to a judge. Given the intrinsic differences between corporate bankruptcy and sovereign bankruptcy, Chapter 11 is impossible to replicate in full.

This has important implications for the role of the IMF – or the role of any senior creditor able to lend to a distressed sovereign debtor. Barring the creation of a workable mechanism to transfer control over debtor policies to creditors – or if not to creditors, to international trustees (as Rudi Dornbusch suggested for Argentina) – it is hard for an entirely disinterested party to have much leverage over a sovereign debtor. The legal powers of any referee are likely to remain limited in the sovereign context; no referee will have the ability to remove the "management" of the sovereign country or to initiate "liquidation" proceedings. Consequently, the ability to link financial support to a country's macroeconomic policy choices will remain the key source of external leverage over a sovereign in default.

It is likely to be quite difficult to find a better mechanism for exercising international influence over debtor policies than access to IMF money. The IMF obviously is an interested party – but it may be the most disinterested of all interested parties. The IMF's seniority and its public mission give it the capacity to focus on more than its own narrow interest in repayment. {57} Moreover, the IMF's governance structure means all major concerns are represented in some way. As a creditor cooperative, the IMF does have a stake in its helping its members. But the debtor countries in the IMF also have cause to worry if the IMF were to systematically favor debtors at the expense of creditors. Lowering the expected "recovery value" on sovereign debt in default would tend to drive up their own borrowing costs.

However, the debate over the SDRM did not generate consensus that the IMF had a crucial role to play in the restructuring process. Many proponents of international bankruptcy believed bankruptcy would be a way to take the official sector generally, and the IMF specifically, out of the sovereign restructuring process. The IMF's role in the restructuring process, and in the operation of the SDRM, was a consistent source of contention – and probably generated more opposition than any of the specific proposals that the IMF put forward. There is not deep consensus on the appropriate role of international institutions in the international system generally, or broad consensus on the role of the IMF in the international monetary and financial system generally. So in some sense, the absence of agreement on the IMF's role in the sovereign debt restructuring process should not be all that much of a surprise.

**Did the SDRM Lead to the Introduction of Clauses?**

Widespread frustration at the market's unwillingness to embrace collective action clauses certainly did much to keep the IMF's international bankruptcy proposal on the agenda in 2002. Supermajority voting to amend a bond's financial terms – the key substantive provision in the most important collective action clause – was ultimately a technical change, not a matter of high principle. English law bonds that contained clauses were common in both the dollar and euro-denominated markets, and evidence of price differentials between bonds with clauses and bonds without clauses was scant to non-existent. {58} The absence of clauses is not an insurmountable obstacle to a successful sovereign debt restructuring and the presence of clauses certainly does not guarantee an orderly debt restructuring. {59} Their importance should not be exaggerated.

Countries that traditionally issued bonds, including dollar denominated bonds, governed by English law continued to use English law during the entire clauses debate. The absence of "clauses" was only the market norm for bonds governed by New York law. Yet debtors were very reluctant to introduce clauses into bonds where their use was not already market standard. Inertia plays a big role in bond documentation. Why risk a deal – or risk paying extra for a deal – over obscure contractual language? In this case, inertia was reinforced by concern that the introduction of collective action clauses in New York law bonds would be interpreted by creditors as a "signal" that the issuer was less likely to repay its bonds, even though there was no evidence that default was more common on English law bonds than New York law bonds. {60}

It seems likely that the IMF's SDRM proposal provided the impetus needed to overcome the market's natural conservatism. Mexico played an enormous role catalyzing the shift in the documentation standards in bonds governed by New York law. The debate over the SDRM allowed Mexico to argue that its use of clauses signaled a desire to end the debate over the SDRM, not a reduction in its willingness to make future payments on its bonds. The heightened attention given to sovereign debt documentation created a risk that if Mexico did not act, someone else would. Change was in the air. The IMF was proposing to override existing documentation with the SDRM. The Group of 10 had put forward model New York law clauses based on English law practice. Creditor groups were pushing new contractual language of their own. Mexico recognized that if it did not introduce its own preferred clauses into the market, someone else might set the new market standard. Finally, the US Treasury had made the introduction of clauses a priority, even going as far as to try to bring together a group of debtors and a group of investors in a joint announcement that the debtors would begin issue – at an undefined point – bonds with clauses, and that these investors were willing to buy these clauses. Mexico's launch short-circuited this effort, but the fact that the US so clearly wanted these clauses no doubt contributed to Mexico's calculus of the costs and benefits: Mexico has strong historical reasons to want a good relationship with the US Treasury. {61}

Mexico and its lawyers (Cleary Gottlieb, but not Lee Buchheit) ended up calling the market right. Mexico had no trouble marketing bonds containing its new clauses, and Mexico-style clauses quickly emerged as the new market standard. The members of creditor groups opposed to these clauses proved to be a self-selected group of activists: their opposition to standard 75% majority action clauses was not shared by others in the market.  Indeed, the market has proved willing to accept clauses that go well beyond those used in Mexico's bonds. Uruguay included clauses that allowed the votes of different bonds to be aggregated to determine the success of a debtor's restructuring proposal, so long as all bonds were part of the same series. (Gelpern, 2003)

Uruguay – and its lawyer (Lee Buchheit of Cleary Gottlieb) – demonstrated both that it was possible to do far more "contractually" than anyone initially suspected and that the market was far more open to innovation than anyone expected. {62} The ability to do so much without a treaty undermined the IMF's case that a politically difficult amendment of the IMF's Articles was necessary to create a sovereign bankruptcy regime.  At the same time, the market's acceptance of Uruguay's clauses could be viewed as ratifying many aspects of the IMF's proposed design for the SDRM, which would have created a restructuring process very similar in key ways to the restructuring process created by Uruguay's new clauses.

**Conclusions**

The debate over the SDRM abounds in ironies. The IMF scaled back the ambition of its proposal while, over time, New York lawyers scaled up the ambition of their contracts. Consequently, clever lawyers ended up drafting clauses that came quite close to doing most of what the IMF ended up wanting to do in its bankruptcy proposal, though such "aggregation" clauses are currently found in a relatively small fraction of the world's stock of international sovereign bonds. But in some sense this is becoming irrelevant –

the market is now migrating toward local currency debt, where there are no uniform restructuring terms – and no aggregation clause spans local currency debt governed by local law and international bonds governed by NY law!

Also, a maverick Treasury secretary in an administration otherwise hostile to the perceived constraints multilateral institutions imposed on the US launched an international initiative that would have required a major extension of international law and limited American (not to mention Brazilian) sovereignty. The Bush Administration, not exactly known for its savvy understanding of the international bond market, succeeded at changing the terms of international sovereign bonds. Robert Rubin, the renowned bond trader who led the Clinton Administration's economic team, never came close.

There was a deeper irony in the entire process as well. The debate would never have advanced as far as it did without the impetus provided by IMF management, Anne Krueger in particular, and the IMF's staff. Specific proposals from IMF management and staff drove the debate forward, and the IMF genuinely came up with an innovative proposal – one in my view far better suited to the realities of the contemporary debt market than any previous design. Yet even though the international community would never have debated a specific proposal without the IMF, it is not clear that the IMF's board room is the best place to hash out the details of the design of a bankruptcy regime.

The IMF's board debate was hindered by two problems – and ironically, neither had anything to do with the under-representation of emerging markets (particularly Asian countries) or the over-representation of European countries on the IMF's board.

First, the interests of the countries of the IMF board – even those representing a single constituency – compete and conflict. The countries with the most at stake in a sovereign bankruptcy regime, the sovereign borrowers themselves, are torn with several distinct interests: their interest as borrowers in private markets seeking access to funds at the lowest possible cost; their interest as debtors who may be unable to pay and need to seek a restructuring, and their interests as members of the IMF who may seek a loan from the IMF to try to avoid a painful restructuring. Brazil needed three chairs on the board, one to represent each of Brazil's interests. When force to choose, though, Brazil opted to represent its interest as an IMF member seeking to preserve access to an IMF lifeline (understandable, given the success of Brazil's most recent IMF program) and as a borrower in the capital markets seeking funds – not its potential interest as a debtor. The IMF never was able to convince debtor countries to engage in the details of its proposed design. Too many interests were represented too indirectly – debtor countries often represented creditor concerns, and creditor countries represented debtor concerns – for dialogue between IMF staff and the IMF's board to ever generate the consensus needed to make the lead to a new regime.

Second, the IMF's internal process is designed to communicate with the IMF's board even though on something as "big" as the SDRM, the IMF needs to communicate with national capitals. The IMF assumed that there was already deep consensus on the need to change and on the type of the problems that the SDRM should address. Its work program consequently focused on hashing out the technical details of a design. It drafted a series of long board papers full of technical details. These papers tend to generate consensus to draft another long paper exploring yet more technical details. They assumed deep agreement on what a bankruptcy regime should aim to do, yet that deep agreement was never present.

Deep consensus on the need for change – and consensus on what a sovereign bankruptcy regime should aim do – ultimately has to come from outside the IMF. In many ways, the obvious analogy between sovereign bankruptcy and corporate bankruptcy creates more problems than it solves. Many find it almost self-evident that the absence of an international analogue to the Chapter 11 "reorganization" process for US firms is a gap in the international financial architecture, and that the world would work better if an international bankruptcy court presided over sovereign debt restructurings. But a vague sense that the absence of a statutory international bankruptcy regime was the source of many problems in the international system hardly guarantees consensus on the right way to adopt principles of domestic bankruptcy law for firms to the world of sovereigns.

Different aspects of domestic bankruptcy appeal to different constituencies. Private creditors like the "rights" afforded to creditors in domestic bankruptcy, notably the right to assume control of the debtor and even force it into liquidation. They, in a sense, want to replicate Chapter 7, or at least create a stronger Chapter 7 threat. Others – debt activists and some academics – like the "protections" afforded to municipal debtors by

Chapter 9 of the US bankruptcy code. They are attracted to the notion of binding arbitration, particularly if a judge would be instructed to place a higher priority on giving the debtor a "fresh start" than on delivering the largest possible return to the sovereign's creditors.

These different – and conflicting – conceptions of what a sovereign bankruptcy regime should do posed a problem for the IMF's would be architects. The IMF neither embraced calls for a more creditor friendly regime, nor calls for a more debtor friendly regime. It focused instead on a more narrow rationale for a new regime – improving the process for approving the debtor's proposed restructuring of its international debt through super-majority voting. Yet it was never clear that there was sufficient political will to create a new multilateral institution to, at the end of the day, address the relatively small problem the IMF identified.

Paul O'Neill's isolation inside the Bush Administration and the absence of broad US support for change are the proximate causes of the SDRM's failure. But the absence of a deep consensus on the need to supersede the existing legal regime for sovereign restructuring – one based on existing debt contracts, as interpreted by the national courts, and muddling through – was the "deep" reason the SDRM failed. Particularly after the threat of the SDRM prompted incremental improvements in sovereign debt contracts, the option of continuing to "muddle through" trumped any desire to create a new regime. Deep consensus on what a sovereign bankruptcy regime should do (and the IMF's role in the sovereign debt restructuring process) does not currently exist, and so long as "muddling through" seems like a viable option, continuing to muddle through is far easier than trying to find a broad international consensus on the basic purpose of a new sovereign bankruptcy regime.

**Endnotes**

1. Fellow, Council on Foreign Relations. This paper though was largely written when I was a Senior Economist, Roubini Global Economics and a Research Associate, Global Economic Governance Program, University College, Oxford. Full disclosure: as a visiting scholar at the IMF in 2002, I was a (junior) part of the team that helped to develop the SDRM proposal.

2. In 1995, the IMF's Legal Department prepared an internal paper that examined the questions that would arise in designing a new legal and institutional framework for sovereign debt restructuring. See Rogoff and Zettlemeyer (2002) at 485-486.

3. In September 2001, Secretary of Treasury Paul O'Neal surprised the world – and his own staff – by stating: "We need an agreement on an international bankruptcy law, so that we can work with governments that, in effect, need to go through a Chapter 11 reorganization instead of socializing the cost of bad decisions."

4. On April 12, 2003, U.S. Secretary of the Treasury, John Snow, stated that it is "neither necessary nor feasible to continue working on SDRM." (Available: http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm) Sean Hagan puts forward three explanations for the falloff in U.S. support for the SDRM: a) the introduction of collective action clauses in New York law bonds reduced the need for more radical reforms; b) doubts about Congressional support and c) opposition from the

financial services industry. I suspect all three explanations are trumped by a fourth: President Bush fired the only strong proponent of the SDRM in the administration. See Hagan (2005) at 390-92.

5. The emerging Asian economies were neither major proponents nor major supporters of the SDRM. Unlike the major Latin economies, most Asian economies hold so many reserves that they no longer worry about their ability to borrow from the IMF.

6. While emerging market debtors often expressed concern that the SDRM would lead them to lose access to IMF financing, private creditors rarely expressed similar concerns. They displayed much more concern that the SDRM would be too favorable to debtors (and to preferred creditors like the IMF), and that this would reduce their post default recovery from crisis countries. Those most skeptical of private sector motivations attribute their reticence to crass political calculations – private creditors can never state directly that they would rather be bailed out than go through bankruptcy.

7. Bondholders can be left worse off if an IMF rescue fails, since the country's debt level will have been raised by the funds now owed to the IMF and the other international financial institutions (IFIs), which are paid even when private bondholders are not.

8. Mexico almost defaulted on its short-term dollar denominated domestic law debt – the famous tesobonos. Russia got into trouble on its GKOs –short-term, local currency, local law sovereign debt. As both GKOs and tesobonos were governed by local law, they

would have been excluded from the SDRM. Indonesia, Thailand and Korea all got into trouble because of the short-term cross border borrowing of private banks and firms – i.e. non-sovereign debt. Turkey and Brazil got into trouble because of a combination of short-term interbank debt and domestic law, domestic currency sovereign debt – not because of international sovereign bonds. Even Argentina – which issued more bonds than anyone else – lost more reserves during its crisis as a result of a run by domestic bank deposits than as a result of payments on maturing international sovereign bonds. Short-term cross-border interbank lines are often guaranteed by the government during a crisis, turning private debts into claims on the sovereign. But few have argued that sovereign bankruptcy is needed so that the governments of crisis countries can nationalize and then restructure private debts. See Roubini, Nouriel and Setser (2004). Former Treasury Assistant Secretary Ted Truman first made this argument in a conference in 2002.

9. O'Neill is quoted in Philips (2002).

10. See Ortiz (2002). Ortiz's equation of default and death can be challenged. Argentina's economy is in many ways more vibrant after its default than it was in the few years before its default. But his views were still typical of the views of many Latin American policy makers.

11. See IMF (2002) and Richards and Gugiatti (2003)

12. International investors now often buy the domestic law, domestic currency debt of

emerging market economies (in balance of payments terms, domestic law debt owned by a non-resident is considered foreign debt), while domestic investors often buy international sovereign bonds (in balance of payments terms, international bonds held by the domestic banking and pension systems are domestic debt). The once clean line between domestic and international debt – with domestic residents owning domestic currency debt governed by domestic law and foreign residents owning foreign currency debt governed by the law of one of the major financial centers – often tends to blur in a more integrated global market. However, the distinction often reasserts itself if times of stress. Argentina, for example, convinced its domestic banks to swap their international sovereign bonds into domestic law instruments – technically loans – prior to its default. It then restructured these loans on different terms than it restructured its remaining international bonds, and resumed payments on the now domestic law, domestic currency debt held by its banks long before resuming payments on its international bonds. See Gelpern and Setser (2004).

13. Quote from Hagan (2005) at 310.

14. For the initial statement of the theoretical risk, see Eichengreen and Portes (1995). For an assessment of the empirical evidence, see Roubini and Setser (2004).

15. *Elliot* had sued to stop payments on Peru's bonds, but it did so on the basis of holding an unrestructred commercial bank loan that it had bought in the secondary market.

16. Hagan (2005) recognizes that "In some circumstances, a distressed debt purchaser's objective of maximizing value can work to the advantage of the sovereign debtor: a creditor that has purchased a claim on the secondary market at a deep discount may be far more willing to agree to a reduction in the face value of the claim than a creditor who purchased the claim at face value."

17. Creditors organized into the "Gang of Seven," a grouping of seven leading financial industry associations. The associations consisted of the Institute for International Finance (IIF), The Emerging Market Traders Association (EMTA), the International Primary Market Association (IPMA), the Bond Market Association (BMA), the Securities Industry Association (SIA), the International Securities Market Association (ISMA), and the Emerging Market Creditors Association (EMCA). The IIF and EMCA tended to be the most vocal members of this group. For a general discussion of the debates over the SDRM, see *Economist*, October 5, 2002 and *Economist*, Feb. 1, 2003.

18. Debtor payment of expenses would solve the "collective action problems" created when committee expenses have to be divided among a diverse set of creditors – particularly when some "creditors" want the ability to trade out of their position and thus do not want to commit to paying ongoing committee expenses. Debtor's worry that committees had little incentive to control their expenses, were a potential source of delay, and would do little to help bring bondholders who were not directly represented on the committee into the deal. See Buchheit (2000).

19. The ability to amend a bond's non-financial terms gave rise to the use of so-called "exit consents": a requirement that bond holders exiting the old bond vote to amend its terms as a condition for accepting the new bond. So long as the bond's documentation allows financial terms to be amended, nothing prohibits "exit consents" from being used in conjunction with the ability to amend a bond's financial – not just its non-financial terms. However, prior to 2003, the documentation of most New York law bonds prohibited the amendment of the bond's financial terms while permitting the amendment of the bond's non-financial terms, often with only the support of 50% or two-thirds of all bond holders. Sovereign debtors consequently made use of these provisions to amend the terms of the old bonds in ways that encouraged participation in the exchanges. See Buchheit (2000b) and Buchheit and Gulati (2000).

20. See Sachs, various articles. Gelpern (2007) notes that the desire to grant debtors a "fresh start" conflicts with creditors' desire (both private and public) to continue to influence the policy choices made by the debtor after debts are forgiven.

21. See the debt arbitration proposals described by Jürgen Kaiser, this volume.

22. See Perry, Guillermo and Serven (2003). See also Hausmann and Velasco (2002).

23. Eaton and Gersovitz (1981) at 289-309 and Bulow and Rogoff (1989a). See also Bulow and Rogoff (1989b).

24. A recent paper by Alexander Guembel and Oren Sussman is more consistent with Argentina's experience. It argues that a sovereign's incentives to pay its external debt are tied to its incentives to pay its domestic debt, and thus the relative balance of political power between domestic bondholders and domestic taxpayers. See Guembel and Sussman (2005).

25. This perspective brings together different strands of recent thinking such as modern bankruptcy theory including modern bargaining theory, especially with imperfect information and the modern theory of capital markets with credit constraints (see Stiglitz, this volume).

26. Several alternative proposals are described elsewhere in this volume.

27. See Bulow (2005) at 229-255.

28. For the initial presentation of a stripped down SDRM, see Krueger (2002). The IMF proposed a version of the SDRM that lacked any stay on litigation. See IMF (2002) at 39.

29. For additional discussion of the difficulties litigating against a sovereign, see Cutler (1995).

30. Hagan (2005) at 365.

31. For a discussion of the difficulties providing formal priority to new financing, see IMF (2002). For a contrary view and proposal, see Bolton and Skeel, this volume.

32. See Moody's Investor Services (2000) and Gulati and Klee (2001).

33. The role of the IMF's proposed dispute resolution forum was widely misunderstood, even if the IMF's rather grand initial name – the sovereign debt dispute resolution forum (SDDRF) – did not exactly help to dispel concerns about the forum's role. The forum was intended to solve disputes arising in the process of counting creditor votes, not disputes between the debtor and its creditors. Think of a county electoral commissioner, not a bankruptcy judge. Its primary role was to confirm the integrity of voting on a potential restructuring and, just as in an election, assuring the integrity of the voting required a process for registering and verifying creditor claims (this is now done informally by the banks managing an exchange offer). See IMF (2002b). The IMF, though, did propose giving the DRF a few powers that were more "bankruptcy judge" and less "election commissioner," notably giving the DRF to power to stop specific litigation against a debtor at the request of country's creditors.

34. Hagan (2005) argues at 343-344: "the Proposed Features [of the SDRM] are designed so that they do not shift legal leverage from creditors to the debtor. Rather [they] … serve to increase the leverage of creditors as a group over individual creditors." The precise impact of the IMF's proposed changes to the voting rules governing a

restructuring on the restructuring terms the debtor will propose is hard to judge – if 75% gives you 100%, or 85% gives you 100%, the vote of creditors in the $75^{th}$ or $85^{th}$ percentile is worth a lot more than it is under a universal approval or even a 95% requirement. The incentive to structure a deal likely to get the support of 75% – or 85% – of all creditors goes up, while the incentives to meet the demands of the $95^{th}$ percentile disappear. The actual impact depends on the difference between the terms demanded by the $85^{th}$ percentile and the $95^{th}$ percentile. However, the impact of the preferences of the potential holdouts in the $95^{th}$ percentile even now should not be exaggerated: a bond market is just that, a market, and to have a market – at least a liquid market – creditors need to hold the same instrument as other creditors. There are network externalities: a bond held by other bondholders is worth more than a bond that is held by only a few creditors, i.e., an exchange deal approved by all but 5% of bondholders would leave the holdouts with a less liquid – and in that sense alone – less valuable asset. Moreover, if the demands of the $95^{th}$ percentile of creditors are too high, the debtor may prefer not to make an offer at all, or propose terms that it expects a significant minority of creditors will not accept. A SDRM-style voting procedure would increase the debtor's incentive to put an offer on the table that attracted enough votes to make the restructuring binding on all. Consequently, if the SDRM's voting procedure specified a 75% qualified majority, the debtor would have a strong incentive to do a deal that appealed to the preferences of the 75-$80^{th}$ percentile of creditors – but not to cater to the demands of a small belligerent minority.

35. Kenneth Rogoff, for example, argued that a greater ability to say no would be one of

the “by-products of the SDRM.” See Rogoff (2003).

36. Both Brazil and Turkey went into their crises with higher debt to GDP ratios than Argentina in 2001. Brazil, however, had already moved to a float, while Argentina had not. Argentina’s debt load needed to be adjusted to reflect the impact of a necessary peso depreciation. The same is true of Turkey’s debt prior to early 2001.

37. See Roubini and Setser (2004) Chapter 9 and IMF (2004).

38. A period of sustained deflation – perhaps facilitated by tight fiscal policy that cut spending by even more than what was needed to match falling revenues – provides a conceptual alternative to a devaluation. However, Argentina’s political leaders were no more willing to accept prolonged deflation and continued output contraction than they were to willing to abandon the currency board. See Gelpern and Setser (2006) 465-488.

39. Argentina had converted $40 billion of international bonds held domestically – about ½ in the banking system and ½ in the privatized pension system – into a domestic law loan a few months prior to its default. The restructuring of these loans would have needed to take place outside the context of the SDRM. Moreover, the loans held by the banking system also needed to be restructured more quickly that other Argentine debts, since the Argentine banking system needed at least one set of performing assets before the deposit freeze could be lifted. Argentina ended up restructuring its domestic law sovereign and non-sovereign debt by fiat, in the pesificiation process. Deposits were pesified at a 1: 1.4

rate, the “guaranteed loans” and other sovereign debt were pesified at a 1: 1.4 rate, but domestic non-sovereign loans were pesified at a 1 to 1 rate. The government then had to issue new peso bonds to compensate banks for the losses resulting from asymmetric pesification. The SDRM would neither have precluded pesification of domestic debt, nor made this process easier. See Gelpern and Setser (2004), and Roubini and Setser (2004).

40. Concluding Remarks by the Acting Chair on Sovereign Debt Restructuring Mechanism – Further Reflections and Future Work (March 2002, BUFF/02/39 EDM 02/3 and 02/4; Concluding Remarks by the Chairman: Sovereign Debt Restructuring Mechanism – Further Considerations (September 2002, BUFF/02/140, EBM 02/92); Concluding Remarks by the Acting Chair: The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations (January 2003, BUFF/03/1, EBM 02/126).

41. Hagan (2005) at 391.

42. See Schleifer (2003) for an argument that debtors benefit from strict bankruptcy law.

43. Both the Belgians, the Dutch, the Swiss and the Austrians all have their own seats on the board, even though with only 25 seats for 184 counties, seats are scarce.

44. For a general summary of IMF’s tortured internal debate on the need to offer a sovereign formal protection from litigation, see Hagan (2005) at 363-368. Divisions

among the IMF's creditor countries were the prime reason why "the IMF was unable to make an unqualified recommendation on this important feature" as "a number of the IMF's Executive Directors remained convinced that the SDRM could only be effective if … a general stay on enforcement was imposed automatically."

45. See IMF (2003) at 33.

46. See Galvis (2003) at 150.

47. IMF staff argued that amending the IMF's Articles of Agreement provided a more efficient means to create an international bankruptcy regime than the negotiation of a new international treaty. They also noted – correctly – that an IMF program likely would continue to serve as the analogue to a debtor's court-approved reorganization plan in domestic bankruptcy, and that the institutions for providing a debtor with legal protection therefore needed to work in harmony with existing institutions for lending to a distressed sovereign.

48. The definitive IMF proposal was published as the *Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism*, April 8, 2003, Available: http://www.imf.org/external/np/omd/2003/040803.htm. The details of the IMF's proposal were also laid out in "Proposed Features of a Sovereign Debt Restructuring Mechanism," Available: http://www.imf.org/external/mp/omd/2003/040803.htm.

49. Rogoff and Zettlemeyer provide a comprehensive overview of preceding proposals for an international sovereign bankruptcy regime in *Bankruptcy Procedures for Sovereigns*. None of the preceding proposals put the same emphasis on aggregated voting among all bondholders at the time the debtor put forward its restructuring proposal.

50. Domestic restructurings can be challenged under the terms of the bilateral investment treaties (BITs) many emerging market economies have signed with the advanced economies. So far, though, attempts to use BITs to challenge the terms of sovereign debt restructurings have had little success.

51. See Gelpern (2004). Gelpern argues that sovereigns should be encouraged to disclose their priority structure ex ante, but would give each sovereign the freedom to picks its own priority system. Ex ante disclosure would strengthen incentives for a sovereign to follow its own chosen priority system ex post. Jeromin Zettelmeyer, David Skeel and Patrick Bolton advocate more radical reforms. They are sympathetic to a 'first in time" priority structure, a structure which would give preference to early lenders to a sovereign in order to discourage subsequent lenders from diluting the original creditors' claims. See Zettelmeyer (2003) and Bolton and Skeel (2003).

52. Gelpern and Setser (2005).

53. See case studies of Argentina and Russia in this volume.

54. Hagan (2005) at 391.

55. After Argentina defaulted and abandoned its currency board, it used some of its remaining reserves to intervene in the foreign exchange market to support the peso. The IMF's objection to Argentina's intervention was a mistake. After it devalued, Argentina was trying to prevent the peso from overshooting on the downside, not trying to avoid any currency adjustment at all.

56. The IMF's initial design required IMF approval before a sovereign could obtain legal protection: this was meant to prevent a sovereign from inappropriately seeking bankruptcy protection. The IMF quickly dropped this proposal. See Hagan (2005) at 361 and 363.

57. Anna Gelpern has noted that senior creditors of a private firm typically care the least about the firm's policies. They get paid no matter what. The IMF, obviously, has defined its mandate in crisis countries rather differently.

58. See IMF (2002) and Richards and Gugiatti (2003).

59. See Roubini and Setser (2004), Chapter 4, for a review of experience restructuring bonds with and without clauses.

60. At least if they did so consciously – it turns out some New York law bonds had been drafted by English law firms and included clauses even before Mexico's trail blazing issue. The clauses had no impact on the market because no one in the market had noticed. It took a comprehensive survey by an Australian economist to discover drafting conventions for New York law bonds were less uniform than people thought. See Richards and Gugiatti. Lots of theorizing about the market impact of collective action clauses was done without ever asking the most simple "behavioral economics" question: do investors buying and selling bonds have any clue what the bond's documentation actually says? It would be hard for the presence – or absence – of clauses to have much of a price impact if investors had no clue which bonds had clauses, and which ones did not. Most evidence suggests that most US investors had little idea which bonds used clauses and which did not: few, for example, knew that Russia's very widely held dollar bonds were governed by English law and included clauses.

61. See Gelpern and Gulati, this volume. Gelpern and Gulati's work is sure to emerge as the standard history of the effort to introduce clauses. They interviewed most of the key players in the debate. Among other things, Paul O'Neill's endorsement of both the SDRM and his staff's efforts to push collective action clauses gave his staff an added incentive to make "clauses" work, which meant introducing them into the New York law market. The Treasury staff – and Under Secretary Taylor – realized that they needed "clauses" to put an end to O'Neill's flirtation with the SDRM. By all accounts, Taylor also believed that the introduction of clauses would make a real difference – he was a true

believer.  His legal staff generally believed that clauses would help, but doubted that they would radically transform the international financial architecture.

62. However, “aggregating” clauses are far easier to introduce in the context of a comprehensive restructuring that effectively rewrites the legal language of all outstanding bonds at one time than through new issuance.  It remains to be seen whether these innovative provisions are a one-off byproduct of a unique period of contractual flux in the New York law international bond market, or if they will be emulated in other restructurings.

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