BANKRUPTCY PROCEDURES FOR SOVEREIGN DEBTORS

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Abstract

The idea of bankruptcy for insolvent sovereign borrowers has been under discussion for a long time, yet has never been implemented. This paper presents various proposed solutions to apply bankruptcy reorganization principles to sovereign debt crises. The current international framework is inadequate and lacks the efficiency of a working bankruptcy system. This paper analyses the case for an international institutional arrangement to deal with sovereign debt problems considering underlying problems in sovereign credit markets. It finds that certain well-designed sovereign bankruptcy procedures may be one step toward a better international institutional arrangement. However, in order to have any chance to be successful these procedures need to be complemented by a broad set of (international) policy measures in other areas.

Zusammenfassung

Die Überlegung, ein Insolvenzverfahren für souveräne Schuldner einzurichten, ist keineswegs neu, wurde jedoch nie in die Praxis umgesetzt. In der vorliegenden Arbeit werden unterschiedliche Lösungsansätze vorgestellt, die versuchen, zentrale Prinzipien einer insolvenzbedingten Reorganisation auf Länderschuldenkrisen anzuwenden. Die gegenwärtige internationale Finanzarchitektur weist nicht die notwendige Effizienz auf, um ein angemessen funktionierendes Insolvenzverfahren nach Muster der Firmeninsolvenz nachzustellen. In der Arbeit werden daher die zugrundeliegenden Probleme in internationalen Kreditmärkten untersucht; ferner wird der Frage nachgegangen, ob eine institutionelle Regelung für souveräne Schuldenprobleme sinnvoll ist. Aus den Überlegungen geht in erster Linie hervor, dass eine institutionelle Regelung einen Schritt in Richtung effizienterer Mechanismen darstellen kann. Um jedoch auf breiter Basis erfolgreich zu sein, bedarf es gleichzeitig einer Reihe von komplementären Maßnahmen im internationalen Finanzsystem.

Resumen[1]

La idea de construir un procedimiento de insolvencia para paises soberanos no es de ningun modo nueva. Sin embargo nunca fue puesta en práctica. En este trabajo se presentarán diferentes modos de acercamiento al problema que datan de distintas épocas. Estos acercamientos buscan aplicar principios de la reorganización después de la bancarrota en paises endeudados en crisis. La estructura internacional financiera actual es inadecuada y no presenta un sistema de insolvencia aplicable. El presente trabajo presenta los fundamentales problemas de los mercados de crédito mundiales y pone en duda la eficacia de la regulación institucional para solventar las deudas de los estados soberanos. Se llega a la conclusión que una regulación institucional de las deudas sería un paso seguro en la solución de los problemas. Sin embargo, para obtener resultados positivos sería necesario una análoga revisión del sistema de finanzas internacionales.

[1] Dedicated to policy-makers in Buenos Aires

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A. ANNEX I

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1. Introduction

> "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor."[2]

This statement by Adam Smith in 1776 is presumably the first known reference to the necessity of a functional sovereign bankruptcy[3] procedure. It is astonishing how topical his statement is today. In a slightly different context, one can hear similar statements such as the following:

> "We lack adequate incentives for orderly and timely restructuring of unsustainable sovereign debts. This can impose unnecessarily heavy economic costs on debtor countries; it can undermine the value of creditor claims; and it can leave the international community confronting an unpalatable choice between a disruptive unilateral default or bailing out private creditors and contributing to moral hazard."[4]

These words were spoken by the International Monetary Fund's (IMF) First Deputy Managing Director Anne Krueger in June 2002.

Krueger's words represent a general diagnosis of sovereign debt problems at present. Debt has been the largest source of capital flows from developed countries to developing countries in the past 50 years. Particularly since the 1970s lending to developing countries has increased drastically. At the same time international financial integration has been moving forward liberalizing trade and capital accounts. The capital flows have enabled a transfer of resources, yet have mostly not brought along succesful economic development. The resulting debt build-up has led to serious repayment problems and occasionally default on debt. The present framework of debt restructuring[5] has proven to be inadequate in dealing with the underlying problems.

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[2] Smith, Adam (1776), p. 590. The context in which Adam Smith made his statement was different than the circumstances today. The "dishonourability" of the debtor in the "Wealth of Nations" results from the governments policy to devalue the real value of debt through seignorage or, as Smith calls it, "the raising of the denomination of the coin" (p. 589).

[3] In this paper, the terms "bankruptcy" and "insolvency"are used as synonyms, whereas bankruptcy is the more commonly used name. The term "sovereign" in turn is to be understood as a synonym for "country" or "state". Sovereign is an appropriate label to underline the sovereign nature of the debtor state.

[4] Krueger, Anne (2002b), Speech at the Bretton Woods Committee Annual Meeting, June 6th 2002.

[5] The term "restructuring" in this paper includes both rescheduling and write-down of debt.

The recent history of sovereign debt crises reveals a progression. In the 80s, academics were mainly concerned with protracted sovereign debt workouts and especially negative externalities that arise from them. In the 90s, the reasons for sovereign default were broadened through the emergence of self-fulfilling panic runs on debt. Despite of the (moving) consensus on the underlying problems there has been less consensus on how to address these problems. Only very recently the gap has narrowed among key actors. This paper presents the current debate and attempts to introduce a good selection of different ideas from different times and angles. How should the international community deal with the insolvency of a sovereign state? Is the reform of sovereign bankruptcy procedures justified and feasible?

1.1. Rationale for the Study

How should the international community deal with the insolvency of a sovereign state? Before going on to examine the history, theory and policy of sovereign bankruptcy, the reader should be aware of a few guiding questions important for this study.

Why is the establishment of a functional sovereign bankruptcy procedure a challenging undertaking?

The central challenge one is confronted with in the case of sovereign bankruptcy procedures is the international adaptation of regulatory systems designed for private market actors. The attempt to govern sovereign conduct on the largely unregulated international arena involves a number of pitfalls. While the economic and legal rationale for a rule-based international sovereign bankruptcy regime may be unchallenged, the problem rises when moving from the rationale to the regime itself. The case of sovereign bankruptcy involves a complex set of concurrent problems. Take for example the concept of debtor valuation, underlying to domestic corporate bankruptcy legislation determining any firm's viability. The concept of the calculation of the value of a sovereign's assets fails. In principle, a country is always solvent. Only its government can be insolvent. A highly indebted country could also raise taxes and cut expenditure in order to acquire the necessary assets for repayment. However, an excessive practice of these measures is practically equal to political and economic suicide. The negative externalities that are created in such a situation for the whole economy move to the center of the problem. A sovereign bankruptcy procedure therefore requires careful mechanism design.

Why is this a good timing for assessing new sovereign bankruptcy procedures?

At the end of 2001 Argentina was heading toward drastic devaluation and dramatic default on debt in a so called „slow motion train crash". Obviously motivated by this disastrous development, Anne Krueger from the IMF surprised the international community. In November 2001 she called for a statutory mechanism creating a new sovereign debt workout procedure called Sovereign Debt Restructuring Mechanism (SDRM hereafter).[6]

The IMF has pushed fiercely for market liberalization worldwide. For this purpose, it had opposed measures preventing the free flow of capital. As of November 2001, it had an influental staff member advocating a number of elements of domestic bankruptcy to be applied to sovereign states. Krueger's proposal had a catalytic effect on the present debate. The new debate is now slightly over a year old, yet it has some predecessors from the 1980s and also between 1995-2000. Earlier discussions all remained fruitless academic disputes with little hopes of being adapted into policy. The IMF's Board of Directors has repeatedly discussed details of a feasible procedure after August 2002.[7] The present debate has become a central issue on the international community's policy agenda. Therefore it also carries a lively promise of an operational outcome.

1.2. Structure of the Analysis

In this paper, the argumentation follows the progression "History – Theory – Policy". It starts out by examining present sovereign debt management, moves on to outline the underlying problems of the present financial system and concludes with proposals for possible future management of sovereign debt. The second chapter

[6] Krueger (2001) A New Approach to Sovereign Debt Restructuring", speech at the National Economists' Club Annual Members' Dinner, Washington DC, November 26.
[7] IMF Public Information Notice (2003) 0306, January 7th.

provides a broad historical survey of sovereign debt crises and looks into the past and present resolution mechanisms of unsustainable sovereign debt. It also examines important concepts on the sustainability of a sovereign's debt burden. The third chapter analyzes the theory of bankruptcy and evaluates the problems that may arise when bankruptcy procedures are applied to sovereign debtors. This analysis involves the incentives of creditors, the incentives of the sovereign debtor and problems in the official sector's approach (IMF policies). The theoretical underpinnings work to facilitate understanding of the fourth chapter. It reviews the history of policy proposals starting with early contributions but emphasising the present debate. The survey selectively deepens the scope on important proposals. It broadly divides the proposals in two camps: those that require statutory reform (i.e. changes in law) and those that require contractual reform (changes in debt contracts). The survey closes with an assessment of feasibility for contemporary policy and attempts to predict policy outcomes.

2. Sovereign Debt

2.1 Sovereign Debt Crises

The history of sovereign debt problems presumably started with the very inception of international lending. Today the most severe problems of sovereign debt, at least the ones that occasionally lead to default and crisis, affect mainly the developing and emerging market world. Yet history reveals that the problems have hit a broader range of sovereigns. In the Great Depression of the 1930s, both the UK and France defaulted on their debt in favour of the needs of their people. In South America, the continent most associated with debt problems today, the problems began as the Mexican government suspended its debt payments in 1914. In 1956, Argentina was experiencing serious debt problems and served as an impetus for its bilateral creditor nations to create the arrangement known today as the Paris Club. This informal restructuring mechanism has reached 360 decisions for 78 debtor nations ever since.[8]

[8] See www.clubdeparis.org -> Presentation.

Reckless borrowing by western creditors (mainly commercial banks) during the 70s, together with the absence of the financial know-how and sustainable policies in debtor countries, eventually contributed to massive debt problems of the developing world. Private capital flows to developing countries had grown enormously compared to official flows. What resulted was a series of debt crises in the 80s. It was Mexico again in 1982 where the crisis first hit. The decade of the 80s also became known as the "lost decade". This was mainly because the repercussions of the widespread crises and a massive debt overhang turned economic growth negative in the entire developing world, and especially in Latin America.[9] During this time, market-based schemes for debt reduction were introduced. In these schemes, the debtor country would buy back debt at discounted prices and try to increase domestic growth through a set of domestic policies specified in the schemes.

As the market-based approach did not prove to be the ultimate solution because debt write-down mostly remained below necessary levels, the schemes were combined with official sector (US government) coordination and funding to facilitate their adoption. This policy went into history as the Brady-plan.[10] The basic idea of the Brady-plan was to increase the certainty of servicing the debt by collateralizing the principal with US Treasury securities in return for some forgiveness in debt. Syndicated commercial bank loans were converted into Brady-bonds, eventually sold to private investors. Bonds now allowed the debt to be traded in financial markets, where it was priced at market value. This way they triggered secondary markets for sovereign bonds to develop, paving the way for the golden age of emerging market bonds in the first half of the 1990s. The bonds effectively substituted traditional bank-loan finance of sovereigns. The development was complemented by widespread capital account liberalizations. All this resulted in a pool of capital flows into emerging markets roughly six times as large between 1991-97 as between 1984-90.[11] By 1995 bonds made out two thirds of emerging market debt. Notwithstanding its undisputable merits, the Brady-

[9] For a detailed survey on the debt crisis of the 80s see e.g. Cline (1995).
[10] This happened in many Latin American countries but also in parts of Africa. Nicholas Brady was the (then) treasury secretary of the USA.
[11] $188 vs. $1000, however declining since 1997. See White (2002), p.17.

plan was not a global success as most of the poorest countries did not enjoy the new tools of securitized finance.[12]

As if every new round of crises started in Mexico, it was the Mexican "tequila crisis" in 1994/95 to present a panic-induced "self-fulfilling run". In fear of the Mexican government's inability to honour its obligations on the foreign currency indexed short-term bonds (the so called *tesobonos*), investors "ran" from the peso. This run proved unprecedentedly disastrous to national liquidity and was eventually settled only through massive capital injection by the U.S. Treasury and the IMF. Similar runs on the currency that had disastrous consequences for the government budget occurred also in Russia (1998) and Turkey (2000/01). The biggest sovereign default in history occured when Argentina defaulted on $141 billion of sovereign debt in 2002.

Runs on debt that have disastrous consequences for the state budget must not always inflict a sovereign debtor in the first step. For example, the East Asian financial crisis (1997-98) revolved mainly around private debt. Although prima facie unaffected, the run can hit the sovereign state's debt burden indirectly. Such a situation occurs when a (fixed) exchange rate collapses as foreign exchange reserves of the central bank deplete and/or when the government is forced to bailout the banking system with astronomic sums to prevent financial collapse[13] (e.g. South Korea, Thailand and Indonesia in 1997/98).

Throughout both remarkable periods of sovereign debt crises (the debt crises in the 1980s as well as since 1995), there have been various efforts to restructure sovereign debt. With the emergence of bond lending the problem of restructuring became harder. While bank loans in the 80s involved at best a few dozens of lenders, the creditor base holding bonds often involves thousands of (often anynomous)

[12] The poorest low-income countries were still suffering from an unchanged massive debt overhang and the new bonded debt did not reach them.

[13] Investors race to sell their domestic financial assets and converte local currency into dollars. This exerts immense pressure on the exchange rate and eventually causes it to depreciate. The necessary action by the country in order to stop the immense capital outflow and defend the exchange rate often involves raising interest rates, which in turn does substantial damage to the real economy. The high interest rates contribute simultaneously to default in local and foreign currency debt, since repayment costs have risen. Bad debts pile up with the domestic banking industry, the government is forced to bail out the banks, and the recipe for a "twin-crisis", a concurrent banking- and currency crisis, is perfect (See "third generation crisis models", e.g. Chang/Velasco (1998)).

creditors. Meanwhile due to the disorderly crises, the capital flows to the developing world have reversed. Since 1997 there has been a remarkable decrease in capital flows.[14]

2.2 Current Sovereign Debt Procedures

Sovereign debt can generally be divided into four categories. These are debt owed to International Finance Institutions[15] (IFI hereafter), bilateral loans to governmental creditors, commercial loans to banks and private loans owed to bondholders.[16] A further classification of claims could be according to seniority of claims or their respective date of issue (bonds).[17]

The access to sovereign debt is not uniform all over the world. Developed countries are able to raise securitized capital in the form of treasury bonds. The same applies for middle-income countries (emerging markets), albeit with higher costs of capital due to the riskier situation. These countries have multiple creditor classes including numerous private sector creditors (banks, bondholders, multilaterals, suppliers) in their portfolios. The low-income countries (e.g. Heavily Indebted Poor Countries (HIPC)) are left with mostly bilateral loans by other governments as well as multilateral assistance by the IFI. The classification into low- and middle-income countries in this paper is somewhat vague and not to be overestimated in meaning.[18] However it is an interesting distinction when laying out reformed mechanisms to deal with sovereign debt, as certain remedy only applies to certain form of debt. For example, many of the proposals discussed in the fourth chapter concentrating on bond finance are unlikely to be of great help for HIPC debt.

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[14] See White (2002), p. 12.
[15] Mainly the IMF and World Bank Group.
[16] See White (2002) p.15.
[17] "In this paper, "creditor classes" is a classification of debt. It differentiates within the form of debt according to seniority and/or date of issue.
[18] Country classification into low-income countries (annual GNP less than $755 per capita, including HIPCs) and middle-income countries (GNP>$755) listed according to World Bank classification at http://www.worldbank.org/data/databytopic/class.htm. (12.12.2002). Middle-income countries include countries such as Argentina, Turkey, Brazil, Mexico and a number of East Asian countries. (also referred to as investment grade countries).

2.2.1. Loans by the IFI and the Paris and London Clubs

The IFI loans by the World Bank and the IMF enjoy a de facto senior priority. Loans that are granted by these institutions also have an exceptionally good repayment record.[19] Under the present provisions, funding from the IFI are mostly attached to a set of conditionality in the debtors policies. In exchange for the loan, the debtor nation commits to make adjustments in its policies.[20] Faced with a continuosly worsening debt situation of the developing world, the IMF and the World Bank jointly launched the HIPC-initiative in 1996. Its objective was to provide debt relief for countries facing unsustainable debt burdens and agreeing to implement an IMF and World Bank program. The HIPC-initiative requires the debtor to continue following macroeconomic structural adjustment policies and some social policy reforms in health and education. The IFI then judge the success of these policies and grant debt relief accordingly. By March 2002, only 26 countries had qualified for debt reductions. For these countries the HIPC will write-down $40 billion, equalling around half of what they owe.[21]

Bilateral loans by governments, at least for a large part, are negotiated in the Paris Club. Commercial bank debt is negotiated in the London Club (since 1976). Neither club is an independent bankruptcy procedure, but informal associations of official and commercial creditors respectively who determine the debt restructuring for a country when claims are due. The Paris Club's decisions require unanimity. The London Club does not require unanimity, but decisions have generally involved the consent of 90-95% of commercial creditors. Paris Club negotiations are usually rapid (historic max. of 15 months) as substantial free-rider problems are not likely to emerge between the same limited set of industrial countries and the debtor merely possesses a right to be heard, not to decide. In contrast, the London Club is much slower with

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[19] This is a *de facto* and not *de jure* priority (White 2002, p. 13). Although Bulow (2002) argues that "*creditors like the IFI, who disproportinately make loans when everyone else wants to take money out and diproportionately get paid off when there are, effectively, other creditors willing to buy them out at face value, are economically junior.*" (p. 9) This paper will not dwell on differing concepts on credit seniority. For a discussion on the implications and the measurement of the good repayment record, see Rogoff (2002).
[20] For information on policy conditionality, http://www.imf.org/external/np/exr/facts/conditio.htm (10.01.2003) Stiglitz (2002) argues that although one would expect the IMF to be an experienced crisis manager, exactly the opposite is true. The IMF advises countries to undertake exactly those policies that have turned out to aggravate problems in similar situations before.
[21] See http://www.imf.org/external/np/exr/facts/hipc.htm, visited 10.03.2003.

respect to the duration of the negotiations. The extreme case of the Polish negotiations starting in 1981 and taking nearly 14 years is an instructive example. This long timeframe can be explained: Banks have an incentive to take a tough stance in negotiations since a too favourable outcome with one country is likely to set a benchmark for future write-down for others.[22] Notwithstanding the general provision of equal terms co-ordination among the two Clubs, often the Paris Club tends to give out more favourable terms due to political reasons.[23] When the official sector gives out more favourable terms, it pays off for private institutions to wait. Waiting to be the last creditor to settle with the debtor is therefore a dominant strategy. This is a crucial failure, since delay of agreement is often very costly to the debtor. Creditors are in a superior negotiating position, and in the end the London Club often closes a negotiation having left harsh conditions for the debtor.[24] The relief granted by London and Paris Club mechanisms provides an overindebted debtor with breathing space for a period of time. However, Sachs (2002) shows that merely 8 out of 60 developing countries with Paris Club restructuring schemes between 1975-96 have been considered cured. Twelve others are in a state of remission, and 40 remain in continuing crisis.

The Paris Club and the IFI work in close cooperation. The IMF, according to its statutes, is supposed to make funding "temporarily available" for emergency relief.[25] Yet for around twenty years the IMF has provided *continuous* assistance to low-income countries with unpayable debts. Arguably, one of the biggest mistakes of the IFI (and many bilateral creditors) has been to determine debt sustainability solely on criteria such as low inflation and balanced budgets. While these are undeniably crucial components of any sustainable strategy, their exclusive and hard-headed compliance can abstract from alarm signals such as negative growth and consequently, an ever-revolving need to restructure, present in too many developing countries. *"The unreality of the debt treatment is also evidenced by endless and thankless rounds of debt renegotiation and IMF agreements*".[26] The

[22] The Polish government was also to be blamed for the delay. It hoped to aquire an especially generous write-down in debt claiming that it was going to be a central force in the political transition process of Eastern Europe.
[23] For example, following the Hurricane Mitch in 1998, special concessions were made to Honduras and Nicaragua.
[24] See White (2002) p. 17.
[25] IMF Articles of Agreement (1944), Article I, Section V.
[26] See Sachs (2002), p. 8. For critique on IFI lending polcies, see Stiglitz (2002), Sachs (2002). The Paris Club and the IFI have used largely arbitrary formulas determining the degree of relief rather than seriously assessing the country's unique circumstances. (Sachs 2002, p. 3) In 1988, the Paris Club first.

principle of debt relief in each restructuring round has been *"to do the minimum possible, just enough to prevent outright disaster"*.[27] The ad hoc nature of the Paris and London Clubs has furthermore been claimed to be adding to uncertainty and intransparency of a debt restructuring process.

2.2.2. Bond Finance

The fourth group of creditors, the private bondholders, play a crucial role in debt problems today. With capital account liberalizations and financial integration of markets together with the following Brady-plan, bond finance gained enormous popularity in sovereign lending toward the end of the 1980s. This was especially the case with middle-income countries. The growth of the number of bonds issued has made communication among creditors (and between debtor and creditors) difficult and the terms to restructure harder. Bondholders are an anynomous mass lacking a forum to negotiate, nothing comparable to the "clubby" discussions in the Paris and London Clubs among diplomats and bankers. Eichengreen/Mody (2000) found that 44% of emerging market bonds under foreign jurisdictions are issued in the UK, 32% in the US and the rest mainly in Japan and Germany.[28]

Bonds issued under UK law usually carry collective action clauses (CACs), as do some issued under Canadian and Japanese law. They allow for a majority of bondholders to change the payment terms of the bonds at bondholder meetings, subsequently binding for everybody. The qualifying majority requirement is usually set at 75-80%. On the other hand, US-issued bonds do not allow *payment* terms to be changed but by unanimity. Usually, US-issued bonds include clauses in contracts that allow terms of the bond to be changed as long as payment terms are left untouched. These "amendment clauses" or "exit consents" are voluntary in nature and enable creditors to accept a restructuring plan by the debtor.[29] However, their non-binding

granted an overall one-third reduction of debt burdens. This has been repeated three times, in increasing proportions each time.

[27] Sachs (2002), p. 9.

[28] Eichengreen/Mody (2000). These figures are subject to fluctuations.

[29] Exit consents are contractual amendments to existing bond contracts accepted by a simple majority of bondholders who have agreed to exchange those bonds for renegotiated debt (excluding payment terms). The attraction of not consenting as a minority bondholder is reduced if the old debt now contains undesirable contractual amendments.

nature can undermine their effectiveness in times of serious instability. As they do not allow for changes in payment terms, they are unlikely to provide decisive relief to the debtor. US bonds further give creditors the right to sue the debtor after default in order to accelerate payment.[30] In contrast, UK bonds only allow the bond trustee to accelerate payment and sue the debtor country, additionally including pro rata sharing provisions among bondholders with regard to the recovery. Consequently, US bondholders have the incentive to sue the defaulting debtor for repayment. Cases of American creditors succesfully suing the debtor country, although fairly rare, include one prominent example: in one of them a private investment house, Elliott Associates, bought $20 million worth of commercial loans guaranteed by the Peruvian government.[31] Following the attempt to restrucure, Elliott sued Peru in US courts for repayment. Elliott achieved an attachment order against all Peruvian assets in the US and Europe. Ultimately Peru settled, paying Elliott Associates $56 million.

2.3. The Sustainability of a Debt Burden

International capital flows carry the advantage of benefiting both source and destination countries, i.e. creditors and debtors. Creditors receive higher returns and are enabled to diversify their portfolios. Debtors in turn are enabled to invest more than domestic savings alone would allow. Capital flows to sovereign states are a significant part of international flows. Ideally, they are designed to finance public sector investment in infrastructure, health or education. If return on this "investment"[32] is high, economic growth accelerates and debt-service is financed. The definition of debt sustainablility for a sovereign is by no means simple. For the sake of argument, take the debt-GDP ratio as a measure for sovereign debt sustainability. Defining sustainability as a non-increasing debt-GDP ratio can be dangerous as this measure is very sensitive to forecasts on growth, interest rates and budget deficits/surpluses. Notwithstanding the measurement problems it is suitable for the analytical case. The debt burden of a sovereign is considered sustainable as long as the debt-GDP ratio is constant or falling in the long run, given investment with a positive net present value (NPV).

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[30] Sometimes 25% of outstanding principal is required to accelerate the claim.

[31] Elliott Associates was a "vulture fund". A vulture fund is a single creditor buying up other claims to increase the credit mass behind the legal claim and thus maximizing expected repayment.

[32] Obviously the term investment is to be understood in a very broad sense here. It comprises state activity in areas such as infrastructure, health, security and education which all provide the framework for tax revenue of the sovereign.

2.3.1. Unsustainable Debt Burdens

In the opposite case of a continuously rising debt-GDP ratio the debt burden of the sovereign at some point inevitably becomes unsustainable. In the situation of an unsustainable debt burden, the true NPV of debt will be below its face value and creditors (as a whole) have no chance to be repaid in full. In reality, a judgement of unsustainability must be on a probabilistic basis: there is always a remote chance that some very low-probability event will change the outlook. For example, it could be that the terms of trade will exceptionally shift in a country's favour or new natural resources are discovered. In the recent case of Argentina, the debt burden is generally considered unsustainable. The IMF has, however, calculated that if primary fiscal surpluses together with growth and interest rates returned to pre-crisis levels, the debt burden could be sustainable.[33]

As borrowing continues and the debt-GDP ratio rises, the probability of the country to service the NPV of existing contracts falls. Real interest rates in the debtor country will rise with the debt-GDP ratio. The higher interest rates make debt servicing more expensive. Increasing repayment obligations can function like a tax on domestic investment (Sachs 1984). Less investment lowers the growth of GDP, which causes the debt-GDP ratio to rise further. If the economy reaches the state where the real rate of GDP-growth plus the primary surplus of the sovereigns budget as percent of GDP remains less than total interest payments, an indefinite increase in the debt-GDP ratio occurs. There remains no other alternative than to restructure the debt and the sole escape out of this downward spiral is an appropriate debt write-down. A debt threshold exists as of where debt write-down increases the economy's growth prospects, eventually reducing interest rates and debt repayable. Value is thus increased for both creditors and debtors. Forgiving debt can not only benefit debtors but also creditors as a write-down might offset higher growth and increase the likelihood of repayment

The current account provides an important element next to the debt-GDP ratio. In an open economy, the current account can also be an indicator of debt

[33] But recovery is only possible if a banking crisis is prevented and depositor confidence is restored. This train has long departed in Argentina. (Krueger 2003)

sustainability. Obstfeld/Rogoff (1996) present a model where in equilibrium, an economy's present value of trade balances, i.e. the net output transfer to foreigners, equals the value of the economy's initial debt to foreigners. In the framework, only if the country is able to produce trade balance surpluses the debt can be payed off. Yet even the current account and the debt-GDP ration together might not be enough to understand debt sustainability in practice. For example, in 1993 Australia had a debt-GDP ratio of 54% and had been running persistent trade deficits since 1976. Faced with similar real burdens, Chile and Brazil could not avoid falling into a debt crisis a few years earlier.[34] Australia never defaulted. Australia's creditors, assured that economic reforms would follow, trusted trade surpluses to emerge in the near future. Australia's avoidance of the crisis suggests that there are other factors at work. Creditors may fear that political and legal institutions in some countries are too weak to ensure future compliance with even moderately higher debt burdens. As countries with negative real burdens like Australia de facto borrow against *future* growth, the confidence of creditors into growth has to be strong enough. This was obviously not the case with Chile and Brazil. If countries are suddenly prevented to borrow against future growth as this is not expected to materialize, a cutoff in lending itself increases the present value of servicing existing debt. If creditors do not expect the situation to get better, a debt crisis can have self-fulfilling elements.

2.3.2. Solvent but Illiquid

Consider the case where a sovereign is forced to default on its debt repayment even though the NPV of its assets and liabilities is judged positive. A creditworthy sovereign may experience this problem because its assets are less liquid than its liabilities. Both theory and experience suggest two different reasons for default on debt. The overall amount of debt may be unsustainable. But it may also be the case that the country is just not able to meet its obligations in the short run, that is, it is solvent but illiquid. This is said to having been the case with Mexico (1995), Thailand (1997/8), Korea (1997/8), Indonesia (1997/8) and Brazil (1998) in the second half of the 90s.[35]

[34] Obstfeld/Rogoff (1996), p. 67. Similar figures as for Australia apply for the USA at present (January 2003).

[35] Illiquidity was observed to be the case especially because of the countries's avoidance of default in private claims and early repayment of loans provided.

Bankruptcy due to pure illiquidity is most unlikely to happen to a perfectly solvent debtor. Some degree of weakness in the policies of the sovereign is generally required to trigger repayment fears among creditors. The exchange rate regime is a prominent example: a number of low- and middle-income countries have had (politically motivated) fixed exchange rates in the recent past. Fixed rates do not allow for exchange rate adjustment to macroeconomic fundamentals. When borrowing in another currency, the countries subject themselves to a serious currency mismatch. Next to mismatches in currency, grave mismatches in maturity contribute to the acuteness of the liquidity problem. The serious manifestation of both mismatches in many emerging market economies has been referred to as "original sin" (Ricardo/Hausmann 2000). Original sin relates to a sovereign's inability to use its own currency to borrow, together with an inability to borrow long-term. The monetary policy of the debtor is not trusted as he could reduce the real value of debt through seignorage if he were able to borrow in the own currency.[36] As a result, the sovereign will only be able to borrow in a "hard currency". The short-term nature of the debt arises as creditors anticipate the possibility of default and borrow only short-term.[37] Short-term borrowing carries an inherent problem: it facilitates the possibility of self-fulfilling runs on debt as the decision on rollover of the credit line is due more frequently.

2.3.3. Insolvent or Illiquid?

An appropriate concept of insolvency and illiquidity is necessary in order to adequately identify and assess the economic measures that need to be taken in sovereign bankruptcy. Especially during the debt crisis of the 80s, crucial misjudgements were made in this matter, as the debt crisis was claimed to be a problem of illiquidity.[38] Insolvency requires a careful assessment of its degree followed by an

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[36] The argument was als Adam Smith's (1776) motivation for a sovereign bankruptcy procedure.

[37] In an attempt to endogenize the maturity structure of sovereign debt, Jeanne (2001) shows how the global financial system, left to itself, tends to give rise to dangerous forms of finance.

[38] Although the distinction between illiquidity and insolvency was made at a relatively early stage, the debt problems of the 80ies were mainly attributed to illiquidity. One argument was that the outstanding amount of debt equalled "only" about a fifth of annual national income (GNP). If every household waived largely a few monthly incomes, the country would be able to pay back this amount without

appropriate write-down. In case of illiquidity, no loss should materialize in any form affecting creditors.

Especially in the light of the developments in the 90s some contemporary theorists no longer believe that it is necessary to draw a sharp line between runs on debt and solvency crises.[39] For several reasons, they are very difficult to distinguish in practice. The distinction is made ambiguous because short-term debt, a characteristic of emerging market economies prone to a liquidity crisis, can be a reflection of "solvency" problems. Moreover, when sovereign debt is subject to a run the actual solvency can easily be diminished. The fundamentally adverse effects of a run occur, whether the run is on an ex-ante solvent or insolvent debtor. An analogy to the two-period Diamond/Dybvig (1983) debtor-multiple-creditor framework illustrates how illiquidity carries the potential to lead to insolvency. If the liquid assets of the sovereign are not enough to pay some of the debt due in period 1 and therefore a run on debt is triggered, funds necessary to generate period 2 output (eventually generating funds for repayment) will be missing. An unfortunate resolution of illiquidity in period 1, destroying period 2 output, hence leads to self-fulfilling insolvency. Moreover, "lasting" insolvency and illiquidity are difficult to separate as an appropriate distinction requires the satisfactory valuation of the debtor. Yet applying market value to a sovereign fails in its very concept. These are reasons why the distinction between insolvency and illiquidity might not always be unequivocal. Nevertheless the conceptual distinction is an important one for policy.

In this paper, reform proposals are discussed as solutions to insolvency, to cases where a write-down of debt makes economic sense. However, this does not mean that the proposed solutions, or elements of them, could not remedy a pure liquidity crisis. The case of pure illiquidity remains where the proper reaction consists of a postponement of payments in a payments standstill or capital injection (as the crisis

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problems. This was a tremendously naïve argument, as it turned out to be. The international debt crisis of the 1980s was one of serious overindebtedness, illiquidity being just the tip of the iceberg.

[39] "*In technical terms, the difference between the panics and inefficient workouts is that the former consists of multiple equilibria, one of which (the "run" equilibrium) is inefficient. The latter in turn involves a unique, although inefficient, equilibrium. In practical terms, one could note that the difference lies between a situation where a creditor collective action problem can cause a crisis, and one where it is an obstacle to its efficient resolution*". (Rogoff/Zettelmeyer (2002), p. 28). Morris/Shin (1998) however argue that a single equilibrium suffices to explain both problems.

would be triggered by exogenous shocks). A proper analysis of it inevitably lead to the discussion on an International Lender of Last Resort (ILLR). This paper does not analyse an ILLR in detail, but it is a debate closely related to the one on sovereign bankruptcy procedures. As the distinction is an important one to understand, reference to some functions of an ILLR is made in the following chapter.

3. The Theoretical Framework of Sovereign Bankruptcy

This chapter provides an introduction into the economics of sovereign bankruptcy. It starts out by asking why bankruptcy law exists in the first place. Furthermore, what are the incentives of creditors and debtors respectively to engage in mutually advantageous debt contracts? What are the *ex ante* and *ex post* incentives of both parties to act in good faith? The rationale of bankruptcy is then transferred to the current inefficiencies in sovereign credit markets. The crucial question is to what extent the inefficiencies justify the creation of a bankruptcy procedure for sovereign debtors. In essence, this chapter is concerned with collective action problems of creditors as well as the debtor's incentives to abide by contractual obligations and to avoid default. The international case further adds interesting elements, namely those of moral hazard and time consistency. In this paper, moral hazard is primarily concerned with current IMF policies that presumably drive creditors to make uneconomic loans and hold debtors from undertaking a serious policy-effort to repay outstanding debt.

3.1. The Theoretical Rationale for a Bankruptcy Procedure

Imagine a debtor and a creditor in a world with complete information, perfectly enforceable contracts and no transaction costs. The contracting parties could specify the contingencies of the debt contract for all possible states of the world and eventually enforce the provisions respectively according to the relevant outcome. In such a world, there would be no need for a bankruptcy procedure.

However, the assumptions above are unrealistic. In the domestic corporate setting, a bankruptcy court provides binding arbitration for debtors and their creditors in the event of financial difficulties. The need for a bankruptcy court exists, as there are transaction costs involved in contracting and negotiations. Not all contingencies can be accounted for in the contracts. Some parties may also be less informed than others. Usually debtors have better information on their project. Deciding on the final allocation of the debtor's assets can take a long time and resources may be wasted while all information is processed. Faced with these inefficiencies, a bankruptcy procedure can be understood as a public good that is not provided by the market.

An efficient corporate bankruptcy procedure accomplishes to balance two objectives: it minimizes the incentives of the debtor to resort to bankruptcy (ex ante) and maximizes the value of the firm after bankruptcy (ex post). The challenge bankruptcy law is confronted with, arises out of the trade-off between ex ante and ex post efficiency.[40] An optimal bankruptcy procedure is also one that is "unemployed". The crucial incentive of functional bankruptcy procedures is the mutual ex ante incentive of creditors and debtors alike, set to work before bankruptcy occurs. Commercial bankruptcy law affects far more cases than those that come to court because of the incentives it sets up for bargaining in the "shadow of the law". The following attempts to evaluate how different these aspects are in the sovereign context.

3.2. Framework of Sovereign Bankruptcy

The same transaction costs and imperfect conditioning of contracts certainly exist in international lending where the prevalence of asymmetric information is evident. The sovereign debtor presumably has better information on his „project", the country. It is harder for creditors to access certified and monitored sources of information on the financial health of the country. Time preferences of debtor country politicians may also be a source of uncertainty. It may for example be difficult to assess the government's preferences with regard to possibly conflicting goals between the following elections and tough contractual obligations towards creditors.

The rationale as such for the bankruptcy procedure in the sovereign context is largely undisputed. The problem in concept resembles the presented trade-offs in

[40] A law that strongly penalizes the debtor upon bankruptcy may induce him to undertake considerable efforts to avoid bankruptcy (ex ante efficiency), but also carries the danger of having undermined firm value in a desperate attempt of the debtor to gamble for better times (ex post inefficiency). A law that provides a weak threat to the debtor and could lead to strategic non-payment (ex ante inefficiency) might in turn invoke the debtor to reveal information on financial distress early, and thus effectively preserve and restore firm value with timely creditor participation (ex post efficiency).

domestic bankruptcy law. The ex post objective of a sovereign bankruptcy procedure is to improve the income and growth prospects of the country. In concept, this could happen with largely the same procedures as a commercial reorganization. The necessary steps would include writing off debt, enforcing a restructuring agreement among all creditors and providing new funds for financial recovery. As one sets to improve the ex post efficiency of sovereign bankruptcy, the ex ante efficiency poses a significant challenge with sovereign debtors. The danger exists that a tough punishment could induce the sovereign to keep dragging obvious default further and gambling for better times. This is sure to undermine value for both parties and apart from that, serious negative externalities in the economy will be created. Harsh ex post conditions for the debtor, imposed by creditors, are not desirable as these are likely to hinder the sovereign from recovery. Nevertheless it is also important that the ex ante incentive for the debtor not to default are strong, particularly as the debtor is a *sovereign* state. In the question of international contract enforcement it is useless to be overly preoccupied with considerations of international law. If one defines *international* sovereign credit contracts as de facto non-binding in nature, there is no need for "legal illusions". While in the domestic context legal enforcement of contracts is possible, "legal illusion" simply means that one should not rely on purely legal considerations in international contract enforcement.

3.2.1. Inspirations from Domestic Bankruptcy Law – Chapter 11

Reorganization

Consider US bankruptcy law as an example for domestic bankruptcy. The U.S. Chapter 11[41] can be considered to be a suitable example of a corporate bankruptcy code for outlining its conceptual transfer to sovereign case due to its position as model-law for many other bankruptcy codes worldwide.[42] Chapter 11 tries to achieve two overall goals: to rehabilitate viable debtors and ensure equality of distribution among creditors. The two key benchmarks of the law are the liquidation and reorganization values of the

[41] 11 United States Code (USC) in Tarullo (2001).

[42] The normative risk one is confronted with by choosing the U.S. legislature for the analysis of the conceptual basis of corporate reorganisation is obviously the argument that other legal systems in the world are thus ignored. But this risk is effectively reduced for the simple reason that many, if not most,

firm. If the liquidation value is judged higher than the reorganization value, the firm will be liquidated and creditors maximise residual asset value among each other. The "reorganization value" is subject to a decision by the supermajority of creditors and the bankruptcy court. Agreement is to be reached where a proposed reorganization distributes the extra asset value fairly and equitably among creditors. Calculation of the alternative values in Chapter 11 is not a mechanical process but involves considerable discretion and an assessment of expected income streams. Nevertheless both directions in corporate bankruptcy are grounded in concepts of market value and provide a rule-based offset for a bankruptcy system. The central difference of sovereign bankruptcy compared to the corporate case is that in the sovereign case reorganization is coercive. There is a public interest to maintain a country as a going-concern. For a sovereign, liquidation is not only unavailable in a technical sense, it is also inappropriate in a normative sense. The same applies also to domestic law regulating bankruptcies of private individuals, who can obviously neither be "liquidated".[43]

Control

Under Chapter 11 proceedings, the management of a company always risks losing control regardless whether it chooses to declare bankruptcy or lets creditors force it to do so upon default. A co-operative management can be granted the possibility to remain in charge with a general permission to conduct the business. The conceptual transfer to the sovereign context for the "debtor-in-possession" provision fails. The comparable tool of displacing an incumbent government is both inappropriate and impossible. Abstracting from the possibility of military intervention, a government cannot be forced to resign by foreign creditors.[44] To what extent the present system of IMF-conditionality in lending resembles outside control on a sovereigns domestic issues is an interesting question, yet will not be elaborated on here.[45]

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other countries' laws are actually based on Chapter 11, or on principles very similar to those in Chapter 11. See Schwarcz (2000), p. 119.

[43] Private individuals insolvency law, e.g. US Chapter 13 and German §§ 17, 18 InsO.

[44] Although this used to be different in earlier times. Britain, France and Spain intervened in Mexico during 1859-61 on behalf of the creditors. The finances of Egypt (then under the Ottoman Empire) were taken over by British and French functionaries. US Marines took over control of the Dominican Republic's customs revenues in 1905 and Nicaraguas in 1911. (Obstfeld/Rogoff 1996, p. 352).

3.2.2. Creditor Incentives

The creditor base of a (middle-income) sovereign debtor is broad and anonymous. In the following creditor ex ante and ex post incentives are measured against the yardstick of Chapter 11. The main elements of Chapter 11 are a payments standstill, the debtor-in-possession (DIP management & finance) provisions and supermajority voting to successfully restructure the debt (and restrain creditors unwilling to abide by the terms). The problems discussed below are problems of collective action. They can all effectively hinder individual creditors to act in a collectively utility-maximizing manner.

Stopping A Grab Race

A grab race on debt is the classic ex ante collective action problem. Consider an analogy to the prisoners dilemma in the classic Diamond/Dybvig (1983) model on bank-runs. In the event of bad news and looming default, every creditor has the incentive to assure full repayment of debt. As the assets of the debtor are less liquid than its liabilities and they are perceived to be insufficient to repay all outstanding debt at present. This is why every creditor has an incentive to race in order to have any chance to be repaid in full.[46] Due to sequential servicing, the debtor would not be able to honor the credit last in line and therefore creditors withdraw capital. On one hand, sovereign debt is formally not subject to the same sequential servicing as bank deposits in Diamond/Dybvig. However, it has been argued that sovereign debt generates a similar possibility for contract design to cause a "country run" that could make everyone worse off. As a debt crisis is unfolding, creditors "rush to the exits" and worsen the painful default and the disorder that could have been avoided.

A "payments standstill" under Chapter 11 is implemented to provide the debtor protection from claims of creditors for a limited period. In the sovereign context, this will happen in the form of a unilateral suspension of debt of the state, but in the sovereign case a broader scope with capital outflow controls might become necessary.

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[45] See Cornelli/Felli (1995), p. 75

[46] A run leads to the abandonment of investment, profitable and unprofitable. The socially optimal outcome of all creditors rolling over is not going to materialize because the individual dominant strategies

The biggest benefit of a standstill is that it impedes the assets from running out of the country due to panic. It cancels the payment of interest and principal during the standstill. Under the status quo, the debtor can, in principle, institute this standstill unilaterally. For reasons to be explained, a sovereign debtor is usually reluctant to do so unless the situation becomes extraordinarily unsustainable.

The dangers of an officially sanctionded standstill in the international context is also worth mentioning. The application of a standstill in the absence of credible „ground rules“ on its use could generate significant litigation on issues such as when it should apply, for how long and what exceptions should be allowed. If a standstill is an option but the ground rules are not clear enough, creditors could rush for the exits at the weakest signs of problems in the anticipation of the automatic suspension of payments and a possible bankruptcy procedure. In this manner, the option of a standstill could carry a self-fulfilling trigger and worsen the ex ante collective action problem of creditors.

The management of collective action determines not only the consequences of creditor behaviour before the crisis, but also ex post during restructuring efforts. In addition to the halt on payments, a standstill could also comprise a legal stay. A legal stay can be imposed to protect the debtor from litigation by its creditors during the period of reorganization. Suppose a debtor defaults and imposes a unilateral standstill on repayment. Given unilateral debt suspension in the absence of a simultaneous officially sanctioned legal stay on litigation, what can result is massive creditor litigation, a creditor "rush to the courthouse". The problem may be worsened if individual claims are bought up by a "vulture fund" (the likes of Elliott Associates) which then uses the total aggregated value to push for repayment with enhanced force.

Debt Restructuring & Restraining Holdouts

After the debtor has defaulted and is renegotiating the debt, a possible free-rider externality exists. The reason why any creditor would voluntarily write-down debt is that he expects to raise the probability of recovery if the nominal value of claims is

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of the creditors make them choose to withdraw. With this sort of a run, both creditors and the debtor end up loosing and the outcome turns Pareto-inferior.

reduced. But in the absence of coercive provisions it may be impossible to reach an agreement when there are many creditors. Once restructuring efforts have started and the debtor is looking to reach an agreement with a majority of the creditors, some minority creditors might not consent to the terms. These creditors lie low until agreement has been reached only to reappear later to claim better terms. Thus they benefit from other creditors restructuring their debt without sharing the cost. The probability of recovery will be increased for creditors who "holdout" and stick to their initial contract. Theoretically, in equilibrium no creditor will agree to a voluntary debt write-down if they can hope to take a free ride on the agreement of others. This collective action problem clearly exists for bondholders. The trend from bank loans to bonds in the 90s has worsened the holdout problem. The creditor base widened and inter-creditor communication became harder.[47]

As long as unanimity is required to reach a decision, the incentive to holdout remains. While the pure unanimity problem can be (and has been) solved with exchange offers by the sovereign debtor, the holdout problem still prevails. In this regard, having a restructuring plan that, once approved by the majority of creditors, binds all creditors solves this holdout externality. Majority voting makes a decision by a qualified majority of creditors binding on potential holdouts not accepting the agreed settlement. In Chapter 11, this is provided as "supermajority voting". A "cramdown" provision in Chapter 11 permits the bankruptcy court to impose a reorganization against the opposition of one or more uncooperative creditor *classes*. Cramdown is an important feature for a debtor faced with many creditor classes. A US-style exit consent in bond contracts could also solve the holdout problem as far as the new bond terms make the old bonds unattractive (without changing the payment terms).[48]

New Priority Finance

Providing finance to the debtor as well as preferred creditor status to creditors financing reorganization are crucial aspects of any working bankruptcy law. In Chapter 11, creditors who extend credit to the company „in the ordinary course of business"[49]

[47] The basic problem, however, may also affect other types of debt. Banks for example may be reluctant to restructure syndicated loans if the debtor did not manage to restructure bonds.
[48] This way holdouts would be voluntarily drawn to endorse the new bonds.
[49] 11 United States Code (USC), §364(a) (1994) in Tarullo (2001).

are also granted a first priority ("administrative expense") claim. For creditors extending credit outside the ordinary course of business, e.g. new investment, the court guarantees „superpriority" on their claims. Fresh borrowing is permitted when it enhances the debtor's prospects for recovery and is likely to increase market value of the firm.

Upon default and the following the lack of liquidity, countries also need to attract money to fulfill general obligations. There is a strong case to ask existing creditors to provide this fresh money (Krugman 1988). The situation is similar to the holdout problem. Assume there is a threshold amount of money needed to restore debt sustainability in the country. Only if an investor believes this threshold amount will be provided by the creditors including himself, he will participate. The promise to provide official finance will lower the threshold amount and the collective action problem may be less severe. (If official finance is relatively small compared to the absolute size of the package, this effect will not be very big). New money has a positive externality on the debt burden as long if it contributes to growth and a fresh start of the debtor. Priority finance following default is a crucial aspect in working bankruptcy mechanisms. If a fresh start is not appropriately ensured and does not carry the hope to increase value, the purpose of creditor concessions during restructuring is defeated.

3.2.3. Debtor Incentives

Commitment and Signalling

A sovereign state is formally neither subject to international nor foreign domestic law and it enjoys immunity abroad with regard to its political representation and functions. However, concerning the commercial activity of the sovereign, this immunity is often waived. The sovereign thus agrees to make commercial claims against it "enforceable" in foreign courts. The Foreign Sovereigns Immunity Act (FSIA) in the US and the State Immunity Act in the UK in fact could be seen as legal enforcement technologies in creditor's hands. In this connection it becomes questionable how far "legal illusion" (as defined above) is still valid. Two scenarios are possible. First, the theory of "legal illusion" is still fully valid and the voluntary waiving of immunity by borrowing sovereigns is a signal of co-operativeness, but effectively nothing but "friendly phrases". Or second, immunity waiving actually grants the creditors effective legal means against the debtor. The case of Elliott Associates vs. Peru suggests that the latter holds true. An American court granted the creditor an attachment order for Peruvian assets.[50] Peru eventually settled and payed a high price ($56 million settlement vs. $20 worth of claims). By subjecting itself to a foreign jurisdiction, the debtor signalises his utmost willingness to undergo all efforts to repay. From the perspective of the debtor, the immunity waivers are therefore an effective "*commitment vehicle*" (Bulow 2002) for being able to borrow in the first place. In this environment, defaults can hardly be strategic (lack of willingness), but mostly due to a „true" non-ability-to-pay.

Concerning commitment and signalling, a similar argument can be elaborated taking foreign issued bonds and examining them with regard to the governing law under which they are issued. According to the Eichengreen/Mody (2000) calculations, 44% of (foreign issued) sovereign bonds are issued under UK law, and 32% under US law. As the UK provides the debtor with majority action protection with Collective Action Clauses (CACs) in the event of default, the question rises why not all bonds of all sovereigns are issued in London? In effect, debtors are in a state of selling bonds, not preparing for future restructurings. It is clear that no debtor would like to be assessed to be in the situation of prospective default. CACs, from the point of view of the issuer, are regarded to be „*extraordinarily useful at the end, but distinctly unromantic in the beginning*".[51] The (un)romance obviously prevails: some brave sovereign borrowers have even gone as far as to delete the protections offered by US bond contracts (e.g. exit consents) as a visible demonstration of their commitment. As debtors want to credibly precommit to repay and demonstrate absolute willingness to pay, they choose the US.

Sovereign Collateral

In order to credibly commit to a cooperative behaviour a sovereign can consent to waive its immunity or expel other protections on offer. Furthermore, this can be particularly necessary as obligations of the state in the form of bonds lack explicit

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50 In a situation of attachment order, the sovereign's funds and mobile assets (monetary or real) can be attached by creditors. An international investor is quoted of having threatened to "capture every Aeroflot that lands abroad" following the Russian governments (1998) announcement to cease payment to bond-holders.

51 See Buchheit/Gulati 2002, p. 34.

collateral.[52] In the absence of credible coercion, nothing formally impedes the debtor to repudiate the debt. Therefore if commitment and signalling set ex ante incentives, concrete ex post costs have to exist that make the sovereign pay.

In the 1980s academics devoted considerable attention to why sovereigns repay in the first place. Some papers came up with reasons why unilateral default bears a number of indirect non-default incentives. The argument in one of the classic papers on the issue of sovereign debt repudiation, Eaton/Gersowitz (1981), was that an important incentive for a sovereign is *the threat of reputation loss*. What results from unilateral default is a threatening banishment from international financial markets.[53] The debt is payed because the debtor hopes to be able to borrow in the future as well.[54] Considering the effects of bankruptcy protection in the Eaton/Gersowitz-world (where only reputation matters), an orderly procedure shapes incentives only as far as the debtor hopes to improve reputation by consenting to a fair and transparent procedure.[55] The pure reputational view was questioned by Bulow/Rogoff (1989), who claimed that the threat to a sovereign from repudiation has to be broader than just its image in credit markets. In their framework they show that the critical aspect to hinder the sovereign from non-payment is the threat of banishment from markets as *both* future lender and future borrower. For Bulow/Rogoff, the Eaton/Gersovitz model fails to explain borrowing if the country can still invest (and is only excluded from future borrowing). To suffer any harm from non-payment, the opposite scenario in which the sovereign gets to enforce international loans should not be allowed to emerge.

Moreover, some developing country government debt contracts contain explicit waivers that make it more difficult for sovereigns that repudiate their debt to engage in

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52 Other forms of obligations, e.g. bank debt, are only rarely collateralized with the property of the debtor In some exceptions loans of developing countries tend to be collateralized with mobile assets of the sovereign, e.g. an aeroplane of the state-owned airline (Ethiopia in the 70s).

53 In their framework, a country seeks smoothing of consumption given risky and volatile income, and that is why it enters international credit markets. Repayment is thus secured up to a certain point. The critical amount is set to where debt does not serve the purpose of smoothing anymore. At this point the country will default. The repayment incentives decrease as the amount of debt increases.

54 This is in fact very similar to the bankruptcy of an individual (US Chapter 13). The only pecuniary incentive for an individual not to default is his hopes to be able to receive credit in the future (abstracting from non-pecuniary incentives such as imprisonment).

international trade. The existence of these waivers supports the assumption that creditors can impose *direct* sanctions on a sovereign debtor affecting output.[56] Creditors can disrupt the intra- and inter-temporal trade of an uncooperative sovereign debtor by forcing it toward autarky. Given the pervasive use of credit in international trade, intra-temporal trade could be reduced to barter. The threat is likely to be clearer for a small debtor nation with limited international trade powers. When a debtor has remarkable power on international markets, its negotiation position is stronger because the threats of trade losses are mutual. A debtor with high participation quotas in international trade can effectively threaten to obstruct the flow of goods and services (Klimenko 2000). Through a set of financial and trade impediments, creditors can threaten to prevent the debtor to gain from output (Dooley 2000). The sanctions suffered by defaulting debtors are a general loss of the country's reputation in credit markets as well as output costs that may be severe. For all these reasons, the present system can be described as one that involves a remarkable incentive to avoid default.

Uncertainty and Delays

At present, the ex ante incentive for countries not to default is strong. This worsens the ex post hardship of restructuring. Experience suggests that countries will gamble for redemption and follow every potential glimpse of hope before defaulting and attempting to initiate negotiation efforts. The looming uncertainty concerning the messy consequences of having to deal with a broad range of creditors and immense externalities of default in the economy are threat enough to drag a de facto certain default to the extreme. Cline (2002) attempts to formalize the working of this gamble.[57] On the other side, delays on the side of the creditors often have to do with determining the true state of the debtor. It is costly and time-consuming to verify the state, both

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[55] On the other hand, a new procedure could enable countries to default *without* loosing their reputation Yet especially if one carries no international "legal illusions", and commitment is decisive, the second scenario could be seen as one that would lead to more strategic defaults (and/or less capital flows).

[56] See also Obstfeld/Rogoff 1996, p. 353.

[57] Cline (2002) proposes a kind of "pre-emptive default", which is thought to be less damaging for the country because it is adopted early. However, he also explains why a pre-emptive default is most likely not going to be initiated. The key point is that even if the damage of waiting for a forced default is greater than defaulting preemptively, the threshold between the two damages (default in period t or t+1) has to be big enough before a government chooses not to hold out for better times and/or gamble for redemption. Even assuming that an objective probability-weighed relative loss of default in period t+1 can be defined, it requires a relatively large increment in the damage from waiting as opposed to defaulting in the first period for doing so. Underlining this difficulty is the fact that the relative severity of forced default (t+1) in comparison to the voluntary one (t) has not been empirically proven.

with regard to the motivation of default (whether the default was strategic or just "bad luck") as well as with regard to the appropriate remedy (whether the debtor is insolvent or illiquid).

3.2.4. Sovereign Risk - Implications for the Cost of Debt

Implications of the Probability of Default

With imperfect information and any positive probability of default, the interest rate of borrowing will exceed the risk-free rate. The higher the anticipated probability of default, the higher will be the cost of capital borne by the debtor. As a result of the messy consequences of sovereign default, sovereign risk augments overall risk beyond commercial risk. The perception of the risk of default is the most common and suitable measure to assess risk. It is the spread between risky and risk-free debt that measures the expected value of losses due to default. The spread between thirty-year US government bonds, considered risk-free, and emerging market bonds averaged 261 basis points in the 1990s. As the medium-risk U.S. corporations spread averages at 139 basis points over the decade, this value is about 88%-points higher than the interest spread on US corporate bonds during the same period. On the other hand, sovereign debt payoff rates following default are similar to those for companies in Chapter 11. US corporate reorganisations averaged quite similar as the average secondary market price for 15 highly indebted countries, at 53 cents on the dollar.[58] Giving faith to this finding, one could conclude that differences lie solely in the anticipated probability of default, since the recovery rates conditional on default have been observed to be similar. Bulow (2002) states laconically that it is thus "*crazy to buy or sell [the emerging markt bonds] without realising they are very likely to be restructured*".[59]

Possible Cost Effects of A Sovereign Bankruptcy Procedure

The access to and the cost of capital add important elements to the debtor's ex ante incentives to undertake all efforts not to default. As becomes evident from the data above, an emerging market debtor already faces a considerable interest burden. If bankruptcy procedures make restructuring easier, it could contribute to ex ante

[58] See White (2002), p. 14-15.

inefficiency if the debtor is less careful to avoid default. On the other hand, a transparent procedure could also provide more ex post certainty and make restructuring more orderly. The issue eventually comes down to the question which effect is dominating.

A way to analyze the effect of debtor protection from market forces is to look at existing procedures where both features, protection and "no protection", exist simultaneously. Recall the case of CACs under UK law, as opposed to US law where unanimity is required. At this point it is instructive to examine the effect of the governing law on bond prices. One could expect that it is not favourable for the price of bonds if legal means existed to make restructuring easier. Eichengreen/Mody (2000) measure bond spreads with primary market data[60] for a number of sovereigns. They take into account that borrowers more likely to default could choose UK law. This assumption, *ceteris paribus*, would imply higher interest rates in London. Interestingly enough, there seems to be a difference in borrowing costs with regard to the country's credit ratings. Whereas debtors with low credit ratings pay more in London than in New York, debtors with a high rating actually raise cheaper capital in London. This suggests that lower ratings need the disciplining effect of US terms. Eichengreen/Mody (2000) suggest that CACs can reduce spreads with 50 basis points for borrowers with high ratings. The evidence is statistically significant, yet it is limited and not unequivocally confirmed by other studies using different methods.[61] According to this limited evidence, there could be a case for quality selection.

An efficient bankruptcy procedure provides the debtor with the incentive to maximize the profits of the projects but it also provides creditors with the incentive to lend at a reasonable rate. If in exchange for the present occasional ad hoc restructurings

[59] See Bulow (2002), p. 5.
[60] The governing law under which the bond is issued can be used as a proxy for the existence of CAC in a bond contract. The spread of a bond is regressed on this proxy and several other variables expected to explain the spread. Data for bond spreads can be generated in two ways: *Primary market data*: one may use the interest on the day of issuance for each bond in the sample, or alternatively: *Secondary market data*: one may calculate the interest rate at a certain point in time by using the actual bond price and the stream of future payments.
[61] The impact on spreads is calculated as an average for each category. Becker, Richards and Thaicharoen (1999) use secondary market data to estimate the impact of the governing law on bond spreads. They argue that the variation of bond spreads over time is larger than any variation that could be associated to the use of different governing laws. Presumably some endogenity expected in the process of the initial offering diminishes over the time the bond is traded.

the infrequent and disastrous crises became less severe, more frequent defaults could in principle even be efficiency enhancing. If the higher likelihood of restructuring drives the cost upwards, why should the possibly reduced losses of creditors not exert downward pressure on capital costs? Indeed, this could be one way of taking the Eichengreen/Mody (2000) results along when rethinking sovereign bankruptcy. If creditors have greater certainty about credible and transparent „ground rules", it should assist them in internalising risk. Countries would also have an incentive to follow sound economic policies as these would then be rewarded with lower cost of credit. It has often been argued that the quantity effect of market protection would also be severe, i.e. the capital flows would decline drastically. However this argument seems flawed. If anything has drained capital flows to emerging markets it is the crises in the second half of the 90s.[62] Moreover, it should be noted that capital inflows are not a virtue in their own right. Even higher costs of capital and lower volumes in flows are not per se welfare decreasing. A crucial momentum lies in the stability of these flows. More ample and more stable capital flows are not unlikely to have an overall welfare-improving effect.

3.3. IMF Policies

The international nature of the sovereign bankruptcy problem requires the study of a final important element, namely that of multilateral finance. The understanding of the implications of multilateral lending on ex ante incentives of the creditors and debtor alike are crucial for the design of a functional sovereign bankruptcy procedure. Although multilateral finance and its current features directly have not much to do with a sovereign bankruptcy procedure, the analysis is important with regard to the incentives these policies can create. In this paper, the „multilateral" is simplified to be only the International Monetary Fund. The following examines problems created by IMF policies.

3.3.1. Moral Hazard and Time Consistency

The inefficiency often linked to IMF policies is that of moral hazard. Moral hazard describes the undesired effect of an insurance, where the insured agents

[62] The capital flows are declining since 1997, see White (2002), p. 17

incentives to prevent the insured event are reduced. When the IMF regularly provides rescue loans (bailouts) in different countries in the event of crises, international investors develop expectations anticipating the next intervention. In this constellation of implicit rescue promises risk is not appropriately assessed (creditor moral hazard) and good economic policies are not followed (debtor moral hazard). Barro (1998) suggests that bailouts increase the probability of sovereign default through moral hazard on both debtors and creditors side. With reference to the $42 billion bailout package for Brazil (1998), Barro asks how Brazil qualified for this support and concludes that *"[t]hey did so mostly by not exercising sound fiscal policies"*.[63] For Barro, Brazil would not have qualified for IMF support with better policies. After discussing the bailouts for Mexico in 1995 and Russia in 1998 he suggests that the IMF changed its name to IMH – Institute of Moral Hazard.[64]

Condeming moral hazard is a complicated task once expectations of interventions have been shaped. Under the present system the IMF (and other official lenders) are stuck in a "time consistency trap".[65] To illustrate, consider an emerging market economy with systemic importance (e.g. Argentina, Russia, Turkey). Ex ante, the optimal policy for the IMF *at present* is to announce limited lending in hopes of dampening the excessively risky lending and borrowing. However, when liquidity is short and a capital account crisis hits one of these countries, the IMF faces the unpleasant policy choice to either leave the country subjected to highly disorganised creditor-runs and an uncertain fate by doing nothing, or providing a large bailout. The optimal policy for the IMF will *then* be to provide the necessary bailout, no matter what was announced earlier. *(See Annex 6.1 for an illustration of the game theory behind this time-consistency problem).*

3.3.2. The IMF - A Lender of Last Resort?

In a domestic context, the central bank has the task to provide liquidity to neutralize shortfalls and to stem financial panic. This function generallty abides by the

63 Barro (1998), p. 18.
64 The original sin is often said to having been committed in Mexico as the approx. 600 basis point spread on Mexican bonds, the „tesobonos", did not matter at all. The tesobonos were effectively risk free following the large bailout of creditors by the IMF and the US treasury.
65 To borrow the Kydland/Prescott (1979) terminology.

Bagehot (1873) principles of liquidity provision in temporary crisis that makes funds available freely at penalty rates. On the international level, the IMF today has been said to perform some of the functions of a lender of last resort (IFIAC 2000). Yet the IMF lacks powers of an international central bank. That is why it is often referred to as a "quasi-lender of last resort" (Fischer 1999). The qualifier "quasi" is meant to distinguish the IMF from a "true" Bagehot-like lender of last resort. The IMF provides conditional liquidity in crisis, yet lacks crucial competences of a central bank. It is equipped with the mere tools of a financial intermediary. *(See Annex 6.2. for important differences between the Bagehot LLR and the IMF).*

Consider the IMF lending to a country with debt servicing problems. In theory, capital injection (i.e. provision of support) only makes sense if the underlying problem is identified as illiquidity and other adverse effects of liquidity provision do not occur. As IMF bailouts should serve solely to fight off temporary illiquidity, there are two types of errors that the IMF is confronted with (Cline 2002). The first type of error would be the provision of support when it turns out there is insolvency. The second would be failing to provide support when the country could have been solvent. These errors underline the dilemma of the IMF. It has been claimed that IMF lending policies have lost their guiding principles, let alone they ever had any credible ones. In practice, the attempt has not been made to define which circumstances require capital at punitive rates, which at non-punitive rates and in which capital should be entirely withheld for reasons of insolvency.

3.3.3. Rules vs. Discretion

To overcome problems of time inconsistency (and thus also those of moral hazard), the Meltzer Commission (IFIAC 2000)[66] advocated clear rules rather than discretion for IMF assistance in the form of strict pre-qualification criteria limiting access to assistance. In case these criteria are not met, the IMF should refuse to lend. Suppose clearly set out rules and pre-qualification criteria for IMF financial help. Suppose further, that a country with systemic importance did not fulfil these criteria for IMF assistance, and therefore did not receive help. The ex post consequences for global

[66] As well as some other authors, e.g. Calomiris (1998).

financial stability of an insistence that ex ante rules be upheld can be devastating. The risk that sovereign default will cause severe economic, financial and political dislocations is great. There is also some risk that it will have destabilizing repercussions affecting the stability of the international financial system. Market participants act on the rational expectation that the IMF stands by, and any policy statement denying assistance will have no credibility in the eyes of decisive market players. An effective ex ante rule would have to completely ensure that the ex post scenario never emerges. An IMF commitment not to bailout would not be credible.

One suggested solution to this time inconsistency problem would be some form of creditor participation in the costs of a crisis, also referred to as a bail-in. Faced with the prospect of having to write down debt, creditors would be expected to extend credit lines and withhold from "running". A possible solution is the strategy of "constructive ambiguity" in IMF action. According to this concept, the IMF would provide help in some cases, but not always. It is designed to randomise bailouts and thus keep the threat of no intervention alive. The idea is that the lively risk of not being bailed out gives creditors the incentive not to grab but to accept a write-down in debt.
Yet this argument has critical pitfalls in practice. It is questionable whether a randomised treatment does not violate the equal treatment rule of IMF members. Closely related, random treatment is not credible as some countries have systemic importance (Argentina, Russia, Turkey), and others do not (Ecuador, Romania, Pakistan). It is no surprise that the latter group of "too-big-to-fail" countries were the ones bailed out in recent history, and the former were left to (more or less) successful private sector restructuring schemes. Hence constructive ambiguity has been attempted already, but neither have the policies been constructive nor ambiguous, but very predictable in the course of events. The strategy of constructive ambiguity has lacked any consistence in rules. But as rules are not credible, their implementation would be a high-risk undertaking for the IMF.[67]

Moral hazard is hard to measure and test. Basically, its existence implies that an insured investor treats a project as being less risky than fundamentals would suggest. The effect on borrowing costs would intuitively be lowering, i.e. moral hazard presents

[67] See Tarullo (2001) for a detailled discussion on rules vs. discretion in the international financial system.

a "multilateral subsidy". There is no model determining bond spreads accurately enough so that moral hazard can be observed by simply taking a look at bond spreads. A natural experiment would be needed where one can claim that in one situation moral hazard exists, but not in the other. However, the issue will not be elaborated at this point.[68] The link between moral hazard and sovereign debt crises is therefore still a tenuous policy basis. Nevertheless the time inconsistency of IMF policies is largely undisputed. Many observers believe that the current system of discretionary intervention displays too much of a pattern when issuing rescue loans. Repeated rescues weaken market discipline. The forced repetition of rescues allows for financial vulnerablities to build up, effectively worsening the fallout at the time of economic and financial collapse. In any case, the present system of anticipated bailouts could not exist in tandem with a new sovereign bankruptcy procedure as the former runs the risk of defeating the purpose of the latter.

4. Sovereign Bankruptcy Proposals

Having looked at the history of sovereign debt problems as well as special problems in sovereign credit markets in considerable detail, it is finally appropriate to evaluate proposals for reformed bankruptcy procedures. Although the main focus of this paper is on more recent contributions trying to address problems brought on by financial integration and liberalization as well as the emergence of bond finance (moral hazard & self-fulfilling runs), a few earlier solutions are also presented. The earlier proposals were motivated by the 80s debt crisis and and are mainly concerned with messy and protracted debt workouts of developing countries.

4.1. Proposals During the Debt Crisis

As a reaction to the disastrous debt crises of the 1980s, market-based schemes for debt reduction were introduced. In these schemes, the country itself took the initiative in reducing the debt stock by buying back debt at discounted prices (Bolivia, Brazil), swapping bank loans for local currency that had to be invested domestically

[68] Interested readers can refer to Lane/Phillips (2000) and Dell'Arricia, Schnabel and Zettelmeyer (2000). for more sophisticated empirical studies.

(Argentina, Brazil, Chile, Mexico), or exchanging loans for "exit bonds" that carried lower principal or interest (Mexico, Argentina).[69] They did not prove to be succesful as their voluntary nature impeded sufficient debt reduction. Soon the schemes were complemented with the Brady-bonds subsidized by the official sector. The Brady initiative has been said to having been the first procedure for sovereigns carrying certain features of domestic bankruptcy procedures, mainly because it was officially sanctioned and subsidized. The Brady bonds provided a number of countries with a new form of bonded finance, but also failed to provide solutions in at least one single case (Ecuador 1999).[70]

While the 80s were productive in developing market-based schemes that eventually culminated in the Brady plan, other proposals were more concerned with the official sector's policies. They attempted to improve the official multilateral approach to sovereign debt problems. One proposal called to use the existing IMF Articles of Agreement[71] Article VIII, Section 2 with a more authoritative interpretation in order to provide legal protection for debtor countries in serious debt service difficulties. This section reads:

> "Subject to the provisions of Article VII, Section 3 (b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.
> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

The idea to make use of the Articles came from Debevoise (1984). In his proposal a country with an unsustainable debt burden would apply for an IMF-endorsed "deferral mechanism" accepted by the IMFs Executive Board. This mechanism would provide a debtor country declaring a unilateral payments standstill with extended legal immunity. He argued that endeavours to halt uncoordinated creditor enforcement against debtor countries had been unsuccessful because courts in the creditor countries did not regard the term "exchange contracts" as broad enough to cover loan agreements. For the case that the IMF endorsement of the mechanism was

[69] See Cline (1995), p. 212-15.
[70] See e.g. Raffer (2000), p. 3
[71] To be called "Articles" hereafter.

not enough, domestic legislation might have to be amended. Soon later the IMF actually called for an *authoritative* interpretation of Section 2 to achieve more uniformity in the interpretation of the Articles, yet never with the purpose of granting debtor countries officially sanctioned payment standstills.

The International Debt Restructuring Agency

Towards the end of the 80s some proposals envisaged a new international organization to deal with sovereign debt problems. In one of them, Benjamin Cohen (1989) called for a US Chapter 11 based "International Debt Restructuring Agency" (IDRA). The IDRA would be a new, independent and neutral multilateral convention. In order to make the creation feasible, it should be a "joint venture" between the Fund and the World Bank. The role of the IDRA would be that of a monitor, mediator and facilitator in sovereign debt problems. Cohen is mainly concerned with creditor free-ride incentives as well as the underprovision of new financing, central aspects in the US Chapter 11. The IDRA would also have the powers to force dissenting creditors to abide by the majority vote in case of restructuring agreements. It could do so as soon as it has declared the proposed solution to be "fair and equitable". The IDRA could force creditors to give concessions to the debtor if relief is considered justified by all parties. Adherence to the agreed terms would be supervised by the IDRA. Debtor good behaviour is defined as „*not seeking more reduction in debt than is deemed necessary to allow for a fresh start*".[72] The debtor is obliged to re-expose itself to the creditor grab race if equitable agreement is being blocked by it. Thus the IDRA could allow creditors to withdraw concessions if the debtor is not acting in good faith. In general, the IDRA is a good example for an early proposal where a new organization with significant powers is created.

Objective Criteria For Bankruptcy

In order to tackle the problem of measurement of debt sustainability, a (then) Swiss treasury official Daniel Kaeser (1990) proposed clear criteria for a sovereign debt workout mechanism. Kaeser wished to solve three problems at once: 1. Create a mechanism for debt reduction, 2. Discourage future indebtedness and 3. Provide countries with sustainable debt burdens to access capital markets at relatively low cost.

Instead of applying bankruptcy procedures to any country experiencing payment problems, the debt service would be measured against export revenues. A centralized registry would be put in motion constantly controlling the indebtedness of countries. As the debt-export ratio exceeds a certain threshold, e.g. 25%, a sovereign would be allowed to petition the mechanism.[73] Below the threshold no petition would be allowed. Debt relief would be granted conditional upon necessary fiscal adjustment policies monitored by the IMF. In tandem with having objective criteria for bankruptcy initiation, Kaeser wished to shape incentives for countries to remain below the threshold. He proposed an insurance fund that guarantees the payment of interest by countries, accessible to countries with sustainable debt burdens. This way these countries could be able to attract cheaper capital. It would also serve as an incentive for sustainable debt management keeping the debt burden under the threshold. Countries with higher burdens would seek assistance of the bankruptcy mechanism. As a debt restructuring should result in sufficient write-down, the country would find itself below the threshold after the procedure, thus being able to attract new finance. In this way the Kaeser proposal also implicitly addresses the underprovision of new finance problem in bankruptcy.

The Kaeser-proposal is a unique because it almost exclusively stresses debtor incentives and abstracts from externalities in creditor behaviour. It provides the concept of an elegant, self-executing and largely market-based solution. However, the proposal may be inapplicable for one crucial reason. The central criterium is the debt-export ratio. As discussed in the second chapter, this poses an undeniable measurement problem and in addition could carry fundamental flaws in validity. The debt-export ratio, although useful for the analytical case, is not applicable in practice to measure true debt sustainability. Consequently the Kaeser proposal, although innovative in nature, is likely to leave too much room for uncertainty.

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72 See Cohen (1989), p. 126

73 The workout mechanism could function under the auspices of the IMF or another international agency.

4.2. Recent Proposals

The following proposals have all been presented after the Mexican tequila crisis in 1994/5. They are mainly divided into statutory and contractual proposals. Statutory proposals are referred to as proposals that require changes in statutes. They are to be understood as changes in law, either national or international. Internationally, this can either be an amendment to existing international treaties or consist of a creation of new international treaties and/or bodies. On the national level it would mean a change in national law.[74] The range of the statutory definition this paper adopts is large. It reaches from international tribunals to relatively small amendments in domestic legislation. In essence, every modification in law is considered to be a statutory change. The second class of proposals do not seek to create treaties or modify law. These proposals envision limited changes in financial contracts. As they wish to modify contracts, these proposals have been often referred to as „Contractual Approaches“. After having examined the statutory and contractual cases, it might be of interest to look into a proposal that does not really fit in neither class, but attempts to use some ILLR-functions for situations of unsustainable debt.

4.3. Statutory Proposals

4.3.1. Jeffrey Sachs (1995)

Shortly after the Mexican tequila crisis in 1994/5, Jeffrey Sachs held an influential lecture titled "Do We Need an International Lender of Last Resort"[75] and consequently "reopened" the debate on sovereign debt restructuring that had calmed in the first half of the 90s. In essence, he argued that the international financial system suffers from inefficiencies and an International Lender of Last Resort (ILLR) would in principle be justified. But as this is unlikely to be technically or politically feasible, the IMF should give up its lending role and instead assume that of a bankruptcy court. Although the proposal lacked crucial details on what such a court should look like, Sachs primarily described the bankruptcy mechanism to apply not only to inefficient

[74] With the idea that when these changes are widely implemented (or at least by decisive countries) the outcome would be a de facto international treaty as everybody abides by the rules.
[75] Sachs (1995), Princeton University Frank D. Graham Lecture, Princeton University, April 20.

workouts but also equally to self-fulfilling debt runs as in Mexico 1994/5. He proposed bankruptcy mechanisms as a solution to both problems, illiquidity and insolvency. The IMF would not have to distuingish between the two types of crises as both would be solved with IMF-endorsed payments standstills in combination with administrative priority of new private lending. This way, the IMF would also not have to sacrifice "tax payer dollars". For Sachs, an ILLR and a bankruptcy court are thus substitutes, alternative ways to deal with self-fulfilling runs.[76] Sachs does not consider debt write-down to be necessary remedy but believes as standstill and new priority finance to restore value will be enough. After Sachs (1995), the discussion on sovereign bankruptcy procedures eventually started to gain momentum. For a comprehensive survey of the debate since Sachs (1995), interested readers can refer to Rogoff/Zettelmeyer (2002).

4.3.2. The IMF Initiative

Soon after Argentina's most recent problems became apparent and the crisis in Turkey (2000/01) was still in fresh memory, Anne Krueger introduced her ideas on an international debt workout mechanism, the Sovereign Debt Restructuring Mechanism (SDRM). The SDRM is largely in the tradition of the earlier ideas by Cohen (1989), and it is also inspired by the US Chapter 11. The SDRMs statutory nature is mainly grounded in the fact that the mechanism would have the force of law in any country where enforcement might be sought. This could be achieved by an amendment to the IMF Articles requiring every member country to ratify it. The SDRM consists of four elements, which relate to the central provisions of Chapter 11:

1. Providing a standstill and an automatic legal stay of claims against the country in crisis to prevent a creditor grab race.
2. Interim financing is given by the IMF, and preferential status is granted to creditors providing new money. The IMF would always continue to enjoy first priority on claims.
3. Restructuring negotiations would be supervised by the IMF and the IMF would also implement this program together with the necessary conditionality in policy.

[76] Sachs (1995), p.12. A similar argument is made in Diamond/Dybvig (1983).

4. Supermajority voting to bind minority holdout creditors to a restructuring agreement.

The standstill would be active if the IMF endorses a request by the debtor-state. It could be extended by the IMF up to a certain maximum period, after which the majority of creditors would have to agree on prolongation. The Funds role would clearly be essential to the success of this system. Krueger claims the IMF is „*the most effective channel through which the international community can reach a judgement on the sustainability of a country's debt and of its economic policies*".[77]

However, the word "IMF" is too prevailing in this first proposal. Every major decision is reached by the Fund. Having had to deal with a lot of criticism with regard to the excessive role of the IMF in her SDRM, Krueger took the opportunity to present a new scheme in the spring of 2002.[78] The updated version of the SDRM substantially reduces the role of the IMF and increases that of creditors. The payments standstill is still granted together with a short legal stay, restricted to 90 days. The renewal of the stay is subject to a decision by a supermajority of creditors, not the IMF. Creditors also decide on preferred status for new money. Negotiations take place under the auspices of a neutral agency, again not the IMF.[79] An IMF program can still be implemented. The new SDRM can thus said to be much more creditor-friendly than the initial SDRM. The SDRM would not have the powers to challenge decisions by the IMF regarding the adequacy of the county's policies or the sustainability of its debt burden. At the same time it cannot override decisions by the majority of creditors and it cannot influence the classification of creditors.

Meanwhile the SDRM has advanced to be a considerable policy alternative that is currently being further developed. By the first week of 2003, the IMF's Board of Directors has repeatedly discussed the feasibility of an SDRM. A blueprint for the design of the SDRM was published on January 7th 2003 (IMF PIN 2003). It foresees the creation of a debt workout mechanism with a standing forum, the "Sovereign Debt Dispute Resolution Forum" (SDDRF). The SDDRF is *the* central element of an SDRM.

[77] Krueger (2001). p. 5.
[78] See e.g. Raffer (2002), Eichengreen (2002), Taylor (2002) and eventually, Krueger (2002a).

Sovereign Debt Dispute Resolution Forum

In order to achieve impartiality and diversity in the composition of the SDDRF, the IMF proposes a voting process. In the beginning, every member country nominates one candidate. These would in turn vote on a committee consisting of internationally recognized experts in insolvency and debt restructuring, that the IMF Executive Board would then vote on. None of the elected members would work on a full time basis, but only be impaneled for single cases. The elected members then appoint a president of the forum to oversee the operations. Upon submission of an actual case, three members would be appointed by the president to handle the case.[80]

Activation, Resolution and Termination

The mechanism can be initiated exclusively by the debtor.[81] Probably, the final mechanism will also endorse a legal stay on claims following its activation. (although the issue has not been undisputed).[82] The SDDRF would have the powers to administer claims, i.e. play an informative and co-ordinatory role in initiation, negotiations and voting. As disputes between creditors and debtors are most likely to arise in 1. the verification of claims and 2. the integrity of the voting process, the forum would also be granted with powers of resolution. As for the verification of claims, it is necessary that no fictious claims are allowed to manipulate the process.[83] The second point, the integrity of the voting process, is also a critical one: even if all claims are bona fide, the danger looms that some creditors with special relations to the debtor will receive undisclosed financial incentives to vote in a particular way.

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[79] Although Krueger left open who would technically run this new "neutral agency". As the new agency would be created through anamendment of the IMF Articles, the danger of IMF-prevalence is alive.

[80] Excluding members with potential conflicts of interest in the particular case.

[81] It is questionable whether the activation of the SDRM will require an independent confirmation, although this is very probable. A related issue is whether a stay on enforcement should be active immediately upon activation or upon affirmative vote by majority of creditors.

[82] It is currently under discussion in the IMF Board whether the SDRM would include a "legal stay" on creditor claims. While some directors at the IMF fear the credibility of the SDRM would be undermined without a legal stay, others feel that it would be a too radical abrogation of creditors rights. This issue therefore remains open. IMF PIN 2003, p. 3.

[83] Illegitimate claims (e.g. former dictators' consumption) are one problem. Notwithstanding the legitimacy problem, these claims would most probably have to be included as they are de jure claims to the state and to hinder ambiguity in verification.

The forum would need to ensure the strictest possible safeguards to prevent abuses and to achieve uniformity in assessment and interpretation. The SDDRF has the right to terminate the operation early if it lacks a constructive purpose for one of the following reasons: 1. provision of false information or 2. general non-cooperation or inappropriate use of the framework.[84] The third possibility of early termination is if a qualified majority of the creditors decide to do so. Under normal conditions the SDRM is automatically terminated upon succesful restructuring by the SDDRF.

Scope of Claims

A point of high relevance is the scope of claims the forum would adjudicate. It is an issue of utmost importance since any conflict or ambiguity in competence is likely to obstruct the smooth working of the mechanism. In a feasible SDRM, *eligible claims* could be:

1. Commercial debt of the central government
2. Central bank claims
3. Claims of public entities and sub-national governments not subject to domestic bankruptcy legislation.

The last two points are still fairly disputed. It is likely that the central government of each member country will be given the option to include, or exclude, central bank and subnational entity claims in the SDRM.

On the other hand, *claims to be excluded* will be those that,

1. Are anyhow subject to domestic bankruptcy law
2. Are loans by IFI
3. The debtor should be enabled to exclude certain types of claims (e.g. trade credit) when it is considered necessary to limit the extent of economic and financial dislocations.

The initial Krueger proposal (2001) included domestic commercial debt of the sovereign into the SDRM next to debt owed to foreign creditors. However, the IMF's

[84] See IMF PIN 0306 (2003), p. 3.

Board of Directors decided that in order to preserve the credibility of domestic jurisdictions, domestic claims that are dealt with under domestic insolvency regulations will most probably remain outside the SDRM.[85] The focus in their case is to strengthen the quality of domestic insolvency legislation, efforts that lie with agencies such as the UNCITRAL.[86] It has also been claimed that the sovereign could exert regulatory influence on domestic creditors if they were included, and pressure them to vote in a certain way. The reasons for the exclusion of domestic debt of the sovereign certainly make sense. On the other hand, the inclusion of this debt would be helpful regarding inter-creditor equity. The exclusion carries some danger of causing free-rider problems between domestic and foreign creditors. Furthermore, a special treatment of foreign debt of non-sovereigns (e.g. trade credit) is an issue what an SDRM should regulate.[87] Capital outflow restrictions, that may possibly need to be imposed, should not be allowed to impede trade finance of the private sector, as this could easily generate a financial collapse.

The final open question remains what to do with the bilateral loans of the Paris Club. Will they remain outside the SDRM altogether or be dealt with as a separate class? Some IMF Directors think that Paris Club claims should remain outside the SDRM but work in close co-operation.[88] This is mainly because the inclusion of Paris Club creditors would require substantial changes in the Paris Club practices.[89] On the other hand, not much, and particularly not the success of the Club, speaks against changing Paris Club procedures. The case indeed exists to include the Paris Club as a separate mandatory creditor class, again with regard to inter-creditor equity.

Each IMF member country has to comply with the certifications of the SDRM and implement them in its territory. Krueger appears to be convinced *that „a dispute resolution forum – small in size, limited in role, and demonstrably independent in its membership and operation*

85 See IMF PIN 0306 (2002), p. 2.
86 United Nations Commission on International Trade Law.
87 For this purpose, Eaton (2002) proposes an escrow account. Trade payment would be held on escrow for the duration of the capital controls.
88 See IMF PIN (2003), p. 2.
89 As explained, the Paris Club has been dealing with a window of claims falling due rather than the entire stock. The Club has also worked on the basis of unanimity.

– *is the best way to achieve this.*“[90] The SDRM remains a hot topic on the international policy debate. This paper returns to evaluate the current outlook in the final chapter.

4.3.3. An International Chapter 9 (FTAP)

The US Chapter 9 applies to bankruptcies of municipalities in the United States. To a certain extent, Chapter 9 is based on Chapter 11. However, two central differences remain. Under Chapter 9, liquidation is impossible and the immunity of governmental powers is guaranteed. Chapter 9 explicitly forbids interference with the "governmental functions of the municipality", whereas Chapter 11 subjects substantially all debtor activity under court oversight. Also, under Chapter 9 reorganization is coercive as a municipality cannot be liquidated. Kunibert Raffer, first proposing an "International Chapter 9" in 1990, saw in Chapter 9 an effective device to balance creditor interests with the welfare of affected citizens and national sovereignity (Raffer 1990). In addition to Raffer, some other authors have also considered Chapter 9 to be the more appropriate code in principle (Sachs 1995, Kaiser 2002). Raffer, Kaiser (2002) and Pettifor (2002) agree that Chapter 9 could also give debt resolution a "human face". Raffers proposal has particularly been embraced by the Jubilee 2000 movement campaigning on behalf of forgiving all unsustainable developing country debt. The campaign has adopted the ideas under the name „Fair and Transparent Arbitration Procedure“ (FTAP). This paper uses the terms FTAP and „International Chapter 9“ as synonyms.

An FTAP requires an international bankruptcy court, a "neutral court of arbitration" (Raffer 1990), that convenes on an ad hoc basis and consists of debtor and creditor representatives.[91] Moreover, an attractive feature of the US Chapter 9 is that it includes hearings of stakeholder groups, such as employees and citizens of the municipalities.[92] This is certainly a point of relevance in the sovereign context considering the immense negative externalities of sovereign default affecting citizens. If problems of democratic legitimacy can be solved, civil society hearings would ensure

[90] See Krueger (2002c), p. 7.
[91] Debtors and creditor rerpresentatives would be equal in number. They would elect an n:th person to achieve and uneven number.

participation of affected citizens. The court would also judge whether debt contracts were legitimate or whether they were the product of reckless borrowing by corrupt government officials or dictators. Raffer claims that an International Chapter 9 would require only minor statutory changes. As the majority of sovereign debt is governed by US or UK law, an amendment to these sovereign immunity legislations (granting sovereigns immunity against litigation when a Chapter 9 procedure is started), should be sufficient.[93]

The FTAP emphasizes the „protection“ of the poor. Any restructuring that is implemented, needs to ensure a certain existential minimum of the population. The government should still have the possibility to provide the basic social services and keep funds free to preserve some degree of fiscal freedom. These amounts could be calculated as a lump sum per head and would be directly written off from debt service. While this procedure is welcome in principle, creditors might doubt the efficacy of this policy as long as questions in equitable distribution and monitoring are not solved. The debtor would have to credibly ensure that these funds are not channeled into the pockets of the political elite. Furthermore, the FTAP claims that governments are often not concerned with the interests of the poor, but are corrupt and maximizers of self-interest. For this purpose, a „right to be heard“ of the poor should be established. The task of representing the poor could be given to local Non-Governmental Organizations (NGO) operating in the country, considered to be the true voices of the people. While a system that takes the interests of the poor into consideration is welcome in principle, the problems rise with the democratic legitimacy of these NGOs. Sovereign states may be highly reluctant to give representative legitimacy to NGOs.

4.3.4. Eliminating Sovereign Immunity Waivers

The Debevoise (1984) proposal called for an authorative interpretation of the IMF Articles granting the debtor-state extended legal immunity against uncoordinated

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[92] Actually this is also included in Chapter 11 in order to provide management with an extra argument for reorganization. The stakeholders themselves however remain in the background in case of substantial decisions.

[93] It could be a sentence of the likes of „*starting international insolvency procedures voids all waivers of immunity relting to this case*“. The UK and US governments would then effectively close their courts to claims against other countries in the event of bankruptcy.

creditor claims in the event of bankruptcy. However, as explained in connection with the debtor's incentives, such legal immunity might not be desirable ex ante. If the waivers of sovereign immunity are the only „enforcement technology" in creditors hands and the only „commitment vehicle for repayment" of the debtor, their waiving carries the danger of draining international sovereign credit markets completely.

This argument of forcing sovereign states into complete immunity leads directly to a final contribution under the umbrella of statutory changes. A prominent proponent of the policy is Bulow (2002).[94] In his proposal the symptom consists of moral hazard on both debtors and creditors side. The disease underlying to the symptoms are the waivers of sovereign immunity. "*If the modern view of moral hazard is right, and debtors will borrow as much as they want and creditors will make uneconomic loans, then a feasible solution would be to waive these rights to enforce contracts anywhere else than in the debtor countries themselves.*"[95] Bulow notes that many emerging market and developing country policy-makers have a bias toward "socially inefficient budgets".[96] Debtors borrow too much and their very ability to do so internationally further distorts this. "*There becomes a question of the extent to which we should allow outside enforcement technology, say the laws of the US and Great Britain, to enable third world governments to borrow more than they could manage otherwise*".[97] While domestic bankruptcy systems involve trade-offs and a paternalistic desire to control the debtor's ability to pay, Bulow's international solution would be radical, but presumably effective. The central motivation is to shape incentives in order to shift borrowing on domestic jurisdictional grounds, as only there creditors would have the protection of the law.[98] For Rogoff (1999), the elimination of sovereign immunity waivers would contribute to "*put [international] equity and debt finance on a more even footing*".[99] The sovereign debtor would effectively be in the same boat as the private creditors. In this system, debtor countries could gain an incentive to try to create conditions that would cause residents to repatriate their foreign capital. Good policies of democratic governments would be rewarded since they are most likely to continue receiving finance, but by the same token the risks of lending to corrupt governments will shoot up. Bulow realizes that the

[94] See also Rogoff (1999), Bulow/Rogoff (1990), Hurlock (1995).
[95] See Bulow (2002), p. 15.
[96] In other words: they are corrupt.
[97] See Bulow (2002), p. 7.
[98] A similar point is made by Krugman (1998). Trying to decrease the foreign debt leverage of domestic debtors is a feasible way to reduce the country's contagious vulnerability in crisis.
[99] See Rogoff (1999), p. 38.

overall amount of lending would certainly decrease in the short and middle run but states that is not necessarily bad. This holds especially true keeping in mind that there is no evidence on the general beneficiality of opening capital markets for sovereigns in the way they have been opened.

Critics of the Bulow-approach like to point to the difficulties eliminating sovereign immunity waivers brings with regard to international human rights law guaranteeing court access to everyone whose rights have been violated (Eichengreen/Portes 1995). Moreover, there has been a general trend away from sovereign immunity and this is getting stronger in recent years (Paulus 2002). Eliminating the waivers would run contrary to this trend. Roubini (2002) is particularly harsh to criticize the Bulow (2002) approach. He reminds that of the crises of the last decade, only the most recent one in Argentina had mainly to do with foreign issued debt of the government. In Asia, the crises were caused by private liabilities. In Mexico, Brazil, Turkey and Russia most borrowing, although public in nature, was issued at home.[100] In virtually all these cases the foreign currency liabilities of the private financial system were subject to a run in tandem to the run on sovereign claims, mostly determining the final severity of the crisis. In consequence, as long as the ability of the private sector to borrow internationally is not restricted, restricting the sovereign's ability to borrow internationally runs the risk of being toothless. The needs of the sovereign could just be financed indirectly (e.g. over the banking system).

Roubini (2002) is certainly right. A broader strategy is indeed necessary to make the immunity waiver elimination a success. Two of these measures could be the following: *1. Correcting the bias toward debt finance*. Rogoff (1999) states that one crucial problem today is the strong legal bias toward debt finance in international lending. The predominance of debt finance (mainly in the private sector) discriminates equity finance and foreign direct investment (FDI). The latter forms of investment would be more desirable as they include an automatic device for risk sharing. Moreover, as short-term debt has recently been a considerable problem, FDI and other equity finance would cause the maturity structure of debt to expand and thus contribute to more stability. Less foreign (short-term) debt would certainly have been considerable remedy for the

East Asian crisis. *2. Keep the IFI out of the bailout business.* When investors engaged in Mexico, Turkey, Brazil and Russia, where the problem debt was issued at home, it was because they knew they would get bailed out in countries "too-big-to-fail".

4.4. Contractual Proposals

The contractual solutions for sovereign debt workouts first entered the debate after Mexico 1994/5. They apply first and foremost to bond contracts. Effectively, the remedy concerns mostly middle-income countries (emerging markets) as bonds are not a considerable issue with low-income country debt. Considering the broad use of sovereign bonds, it is certain that if an emerging market sovereign experiences debt-servicing difficulties, bonds will be a considerable part of the problem.

4.4.1. Collective Action Clauses

The modification of contracts consists of including Collective Action Clauses („CACs" herafter) in bond contracts. The most prominent advocate of CACs has been Barry Eichengreen.[101] Together with Richard Portes (Eichengreen/Portes 1995) he advocated the potentially useful contribution of CACs in sovereign debt restructuring. The solution that Eichengreen/Portes develop is an approach of voluntary ex ante arbitration. CACs would serve to shape creditor ex ante incentives through the anticipation of majority voting. In general, one can lay out four different forms of CACs (Dixon/Wall 2000):

1. *Majority action clauses (MACs),* that allow a qualified majority of creditors to change the terms of debt which is binding on dissenting bondholders. This majority threshold is usually set at 75%. This is the provision most referred to in the literature, since it is the central element dealing with the stranghold of unanimity. Often MACs and CACs are used as synonyms.
2. *Collective representation clauses* determine the mechanisms with which discussions among bondholders and in their relation to the issuer are co-

[100] Domestic and foreign currency issued locally: GKOs in Russia, Tesobonos in Mexico and other debt in Turkey and Brazil. See Roubini (2002), p. 12.
[101] See Eichengreen/Portes 1995, Eichengreen 2000, 2002, Eichengreen/Mody 2000.

ordinated. These clauses address the practical problems created by widely disseminated bonds, especially as many are registered in bearer form, lacking central registry of the current holders.

3. *Sharing clauses,* ensuring that all repayments by the debtor, irrelevant of the initial addressee, are distributed pro rata among creditors. A sharing clause thus removes the incentives of hold out creditors to act against a majority agreement.
4. *Non-acceleration clauses* require a minimum threshold of bondholders before a claim cane be accelerated and immediate repayment of debt can be demanded. This threshold again is usually set at 25%, matching reciprocally with the majority action threshold.

CACs are not a new idea. As already mentioned before, the UK and Canada usually include at least MACs in bond agreements. The widespread use of CACs has been advocated by a number of expert committees, most prominently by the Rey Report (G-10, 1996).[102] The message was also echoed by a series of G-22 and G-7 reports and declarations. The G-7 then placed the issue on its agenda for reform of the international financial system. Their adoption has also been advocated by the IMF. They have even been discussed as a necessary complement of an application for credit under the IMFs Contingent Credit Line (CCL – as of 1997). However, the IMF has not come to require their adoption.

4.4.2. Problems with CACs

The First Mover Problem

The further adoption of CACs outside the UK and Canada has been practically inexistent, reflecting the inherent obstacle of CACs. Their implementation cannot be left to market forces and countries because there is a first mover problem preventing them to be adopted autonomously. Buchheit/Gulati (2002) call this a „drafting inertia". The reluctance to adopt CACs exists because countries fear that it will raise their costs

[102] The G-10 report was mainly concerned with minimizing moral hazard for both debtors and creditors. It stated that developments in the direction improving communication between debtor and creditors are the necessary step and they should be market led, but receiving official support as appropriate.

of borrowing. Although this concern is at best speculative and is not supported empirically it is still deeply rooted in the beliefs of many emerging-market policy-makers who oppose CACs. On the side of the creditor community, the same fears exist. A country that adopts CACs could be judged to be more inclined to default. Among the impediments to embrace CACs the moral hazard argument also holds; as long as a bailout can be expected, sovereigns and their creditors will be reluctant to embrace more complicated debt instruments regulating the event of default.

What is likely to become necessary to provide incentive for the exchange is some form of subsidy. There is a case for the international community to subsidize or enforce the CAC use, as a serious signalling problem exists in their adoption.

Aggregation and Transition

A statutory procedure provides a centralized mechanism to aggregate claims across different creditor classes (single bond issues, bank debt etc.) Furthermore, a statutory procedure would naturally apply to all existing claims, not only to new debt issues. CACs cannot directly address these problems. First, normal CACs work issue by issue and do not ensure creditor coordination across groups and classes. Also, CACs would have to be made universal, i.e. applying not only to bonds but all commercial debt of the sovereign, to prevent asset substitution.[103] These difficulties have become known as the aggregation (or universality) problem. Second, there is a transition problem with CACs. When CACs are only included in new issues, it would take a long time before the stock of outstanding debt can positively be restructured.

First to the severity of the aggregation problem: One can distinguish aggregation for litigation (i.e. vulture fund action) and aggregation for acceptance of restructuring terms. If CACs set majority thresholds only within classes and not universally, litigation is easier when aggregation to accelerate a claim requires only a fraction of creditors of this individual issue (rather than a fraction of the entire debt). With the traditional MACs alone, this problem certainly persists. However, if other CACs such as non-acceleration clauses and sharing clauses are implemented, this

[103] Friends of the debtor (e.g. state owned banks) may buy some of the existing debt and then vote in his favour.

problem could be solved.[104] The second identified aggregation problem is present in negotiations for restructuring. Single classes will want to be the last to settle with the debtor, believing that by doing so they will receive better terms. They will be reluctant to reach agreement in the anticipation that other classes will also continue holding out. This is a serious co-ordination problem across issues that carries the potential to block any acceptable result. Any clause applying *within classes* could not solve this problem as it would not provide for inter-class co-ordination.

The second problem with the adoption of CACs is the transition problem. The negative consequences for liquidity emerge when a „two-tier"[105] bond market develops. In this situation two simultaneous markets exist, one for bonds with and the other for bonds without CACs. Liquidity could be short as the old bonds are considered more attractive from the creditors point of view. The transition period from old bonds to new bonds with CACs will have to be shortened by attempting to exchange old issues with new bonds. Moreover, a further requirement is that this exchange will have to be voluntary. If coercive measures were implemented to force markets to swap, this is likely to lead to litigation. The crucial requirement is that holding out is not a superior option markets are left with. This will be the case only when markets are convinced that higher pay-offs are no longer to be expected.

4.4.3. Proponents of Contractual Reform

Barry Eichengreen

Opting for MACs in debt contracts, Eichengreen/Portes (1995) propose an international „Bondholder Council" to complement the Paris and London Clubs. Creditor conventions should thus be easier to organize. Through a reinterpretation of its Article VIII (2)(b), the IMF should also be enabled to better sanction standstills in the event of panic. Although without clear mandates in its Articles, this „sanctioning" would presumably just remain a form of mere „encouragement". The sanctioning is designed to work together with the MACs in contracts. In some circumstances, the

[104] As this majority threshold for litigation is usually set at 25% of the issue in most proposals, one could think of raising this threshold to say 75% to make litigation increasingly difficult.
[105] Essentially a system with two "rankings" or "grades".

IMF should also be allowed to provide large scale financing to prevent contagion and self-fulfilling runs.

The argument was developed in a more recent contribution by Eichengreen (2000). Compared to Eichengreen/Portes (1995), the IMF-endorsed standstill is now more authorative and constitutes a clear second element of the strategy. The remedy differs whether one is faced with a solvency or a liquidity crisis. A standstills is a fine measure to address liquidity crises but it provide little remedy for problems of debt sustainability since all it grants is a window of time. The MACs then again are designed to facilitate the free riding problems inherent in restructuring, necessary in case of solvency problems where debt write-down is indispensable. For Eichengreen, this difference has important implications for debtor behavior. In the case of a pure panic (illiquidity), the debtor should be able to repay the full amount after the crisis. But in a case of debt restructuring, where write-down is necessary, debtor good behavior needs to be ensured throughout the process.

The IMFs leverage with regard to the debtor would be limited as it would not have powers to remove a standstill (merely to disapprove of it). It is only able to offer the bonus of some lending. However, IMF powers would not be necessary as standstills alone do not require any painful negotiation attempts by the debtor and therefore are unlikely to cause debtor moral hazard. The weakness of the IMF could matter in restructuring where debtor good faith and possible policy adjustments become necessary. Yet as the system relies on realigning ex ante incentives through MACs, it thereby implicitly hopes that ex post intervention turns out to be unnecessary. In order to make countries adopt the MACs, Eichengreen (2000) calls to allow the IMF to increase its available funds and offer more attractive lending terms to countries. The IMF would thus offer the „carrot“ of some (conditional) lending in exchange for the adoption of MACs.

The US Treasury Proposal

After Anne Krueger had introduced the revolutionary SDRM, one of the most expected reactions was that of the US Treasury. Until then, the USA had been reluctant about organized sovereign bankruptcy procedures because "*it is not appropriate for the* *official sector to mandate the terms of debt contracts between countries and their creditors*".[106] The USA possesses blocking minority on IMF decisions, and its stance is crucial for any real international policy change. In April 2002, US Treasury undersecretary for international affairs, John Taylor met this expectation. Taylor (2002a) made it clear that, in his opinion, mechanisms to deal with sovereign bankruptcy in order to be feasible should be market oriented and decentralized. He planned to address failures with a set of clauses very similar to those outlined above (p. 48). The inclusion of other contingency clauses in addition to the traditional MACs can be seen as an effort to mimic what could be done under an SDRM. Debt contracts would include an initiation clause for a standstill to prevent a grab race, a representation clause for organized negotiations between creditors and the debtor. As for MACs, Taylor saw no legal reason why they should not be adopted and issued under New York law as well. The only feature of the SDRM his proposal could not mimc was that of priority finance. Taylor apparently did not see the problem as being that crucial believing that existing IFI finance methods were sufficient. Answering the question on how incentives could be shaped in a way that countries adopted these clauses, Taylor favored the system of „carrots and sticks". Countries implementing the changes would receive lower interest rates for IMF lending and further financial inducements to carry out bond swaps on the existing stock. The „stick" would be the withholding of IMF support if measures are not taken.

The "carrots and sticks" approach carries one crucial flaw: In a situation of looming or existing crisis, interest rates are not likely to play any role in a sovereigns plea for IMF assistance. The provision of capital is desired almost independent of the cost. Requiring different interest rates would in principle also run contrary to the „comparability of treatment" provision in the Articles of the IMF. It could therefore only be accomplished by amending the IMF Articles. But if one sets the initiative to amend Articles, it means statutory reform in the definition of this paper. In the end, contractual and statutory reform might be complementary to a certain degree.

[106] Summers, Larry (1999). Speech at the London School of Economics, June 6th.

4.5. Stabilizing Debt Prices

Lerrick/Meltzer (2001) propose an IMF supported workout mechanism that would stablize debt prices. The substantiation of the problem lies in price dynamics. Consider asymmetric information as a problem among creditors. If liquidity problems force a creditor to reduce a position, it may be difficult to sell this position on the market, because there is only a small group of traders informed about the country in question. This group typically consists of creditors already engaged in business with that country. They may not be willing to extend their engagement, especially since they are hit with the same shocks as the initial creditor. Therefore, in the event of a crisis a group of informed sellers meets the market of uninformed potential buyers. Market prices are likely to be below their fundamental values. Such "firesales" are crucial momenta of self-fulfilling downward spirals.

Lerrick/Meltzer (2001) argue that the key determinant of recent financial crises in the 90s has been creditor moral hazard. For this purpose, they foresee an IMF-endorsed standstill during which creditor-debtor negotiations take place, and introduce one element that adresses the price spiral problem: the first objective of an unsustainable debt situation is the prevention of market collapse. Their mechanism allows the sovereign to announce an official bid for the repurchase of its debt. A debt write-down would be accompanied by *an official floor of support* for the bond prices to keep them falling under a certain threshold. This official support would come from the IMF in the form of unconditional lending. The Fund could also set the floor price at some 80-85% of the fraction of the debt that is considered sustainable. The moment the bond prices reach this minimum, the IMF would intervene. The floor must be low enough to keep creditors holding on to their claims and provide incentives to restructure. It cannot, however, be too low as this would not be capable to restore market stability.

The only purposes of IMF lending would be to prevent fire sales of bonds, keep their prices at reasonable levels and sustain liquidity during restructuring. In this sense Lerrick/Meltzer present a different assessment of the creditor panic problem: a standstill alone will not stave off the collective action problems. The speculation about the market pricing of bonds will continue. Consequently prices have to be stabilized during standstills. Legal instruments to protect the debtor from litigation by creditors are not necessary. The debt price floor would effectively reduce the incentives of creditors to litigate (if the face value is not much higher than the floor price). A crucial element in Lerrick/Meltzer is the assessment of sovereign insolvency. Correctly identifying insolvency is essential, since the framework should only apply to unsustainable debt situations where write-down is essential.

However, it is questionable whether the IMF could credibly work as a rule-based price-stabilizer in the absence of mandates. Although the Lerrick/Meltzer proposal is not directly a statutory one as no new treaty or organization is created, the changes necessary in IMF policy (e.g. amendment of Articles) might require some statutory reform and thus render it a statutory proposal, at least in the definition this paper has adopted.

4.6. Implications for Policy

4.6.1. A Synthesis of Ideas

Numerous contributions developed in recent history point out different inefficiencies and deliver different solutions to problems around sovereign debt. The solutions emerging for the 80s debt crisis already demonstrated the variety in interpretation. For Debevoise (1984), the crucial point was the possibility of uncoordinated legal enforcement against a debtor. Kaeser (1990) was exclusively concerned with the sovereign debtor's motivation to keep its external debt profile below a certain threshold. And finally, Cohen's International Debt Restructuring Agency (Cohen 1989) is representative for an early proposal for a bankruptcy court modelled after Chapter 11, which unified a number of aspects and motivations.

The more recent proposals eventually widened the scope on the motivation of a sovereign bankruptcy procedure. The Sachs lecture (Sachs 1995) is central because it served as a trigger to (re)start the debate on sovereign bankruptcy. Taking self-fulfilling debt runs and moral hazard as new pivotal phenomena Lerrick/Meltzer (2001) hoped to address the problem by subsidizing bond prices. The Krueger (2001, 2002) proposals for an SDRM picked up ideas from a number of sources, Sachs (1995) and Cohen (1989) among others. On one hand, her views are being challenged by a contractual case made by Eichengreen/Portes (1995), Eichengreen (2000, 2002) as well as Taylor of the US Treasury (2002). Krueger's SDRM indeed carries the merit of having achieved a considerable impact in solution design since it has encouraged the US Treasury to embrace pecuniary incentives for the adoption of CACs. The Taylor proposal is the most important contractual proposal for policy at present, since it represents the views of the US Treasury. By the end of 2002, all contributions to the subject react to Krueger (2002) and Taylor (2002) as it has become clear that policy is going to revolve around these two proposals. On the other hand, the voices advocating a Fair and Transparent Arbitration Procedure (FTAP) following the initial Raffer (1990) proposal for an International Chapter 9 also remain active.

SDRM vs. CACs

The features of the two central proposals the international community is currently discussing, Krueger's SDRM and Taylors CACs are summarized in the following table. For the purpose of illustration the proposals are compared to presently applied proceedings:

Table 4.1.: Key Features of Debt Workouts[107]

Scheme / Feature	Stopping A Grab Race	Financing Reorganization	Restructuring Debt	Restraining Holdouts
Status Quo	Unilateral standstills	IMF lending	Bond swaps (US) + CACs (UK) (Paris Club, London Club)	Exit consents (US) + CACs (UK)
SDRM	Payments standstill plus short legal stay, which may be renewed	Preferred creditor status for new money*	Negotiations supervised by SDDRF *plus* IMF program	Supermajority voting across classes*
US Treasury	Initiation clauses to allow for payments to be suspended		Representation clauses governing rules for meeting	Supermajority voting clauses *plus* arbitration

* to be decided upon by a supermajority of creditors

[107] Source: Miller (2002), p. 4, modifications by the author.

The SDRM aims at a broader range of problems including the preferred status for new money. The Taylor proposal mimics most of the provisions of an SDRM except for the new money problem. Moreover, the CACs of the Taylor proposal are more of an "endogenous variable", as their adoption will not be self-enforcing.

The Taylor-system of carrots for CAC adaption in the form of IMF programs indeed bears a central shortcoming. If IMF lending were the only carrot to implement necessary changes, what would move all countries not having to negotiate an IMF program to adopt such changes? Moreover, would the time consistency problem of the IMF not persist? Recall the much-repeated scenario where a country did not abide by certain policy requirements and crisis hits. The IMF cannot withhold assistance and falls into the same credibility trap over and over again. Knowing that the IMF has an incentive to intervene, countries already sceptical about CACs will not implement reform.

Essentially the same authors that call for CACs have now come to point to the prospective need of changes or amendments in domestic or international law to make CACs a success (Eichengreen 2002, Taylor 2002). The solution could be to amend the IMF Articles and requiring a uniform set of CACs for all new loan agreements in all IMF member countries. The amendment could address the problems of majority action, representation, sharing and non-acceleration.[108] Even with an ambitious contractual solution without any significant treaties to follow, statutes may well become necessary to assure the adequate functioning of the contracts. Eichengreen (2002) calls this a „Krueger-like process for a Taylor-like result“. Amending the IMF Articles will be necessary in any case, but Eichengreen hopes that the outcome would be the market-based solution. Whether the outcome is "Taylor-like", or eventually "Krueger-like", remains open.

Once put into practice, the differences between the statutory CACs and an SDRM persist in a different way. The CAC approach would leave jurisdiction to the national

[108] Funds would be needed in order to underwrite the costs of market-based exchanges to retire existing stock of old issues without these clauses. This is where the World Bank and other regional development banks could join the effort.

courts under which they are issued. Also, outstanding debt would remain untouched until maturing obligations are replaced with new issues containing CACs. Leave aside the problem of transition, and imagine all outstanding debt could be dealt with in a mega-swap. The CACs would still pose mainly three problems.

1. A working voting procedure would need to aggregate across all claims. The question in a CAC approach remains how different outcomes across instruments would be reconciled? This would most likely require making CACs aggregate *across* all creditor classes. However, these kinds of „super-CACs" are problematic and their adoption involves an even stronger drafting inertia than normal CACs.
2. Uniformity of language can hardly be assured across all jurisdictions and across all instruments. Even if identical language is used, this does not yet grant uniformity in judicial interpretation.
3. Laws in some member countries do not provide a clear statutory basis on the grounds of which rights of minority creditors could be modified unvoluntarily.[109]

In the end, the CACs are in fact a distant second to the SDRM in providing assurance on universality of coverage and interpretation. The relative merits of the SDRM lie in its enhanced transparency and accountability since it provides an aggregation mechanism for claims and a standing forum to ensure the integrity of the process.

SDRM vs. FTAP

The Fair and Transparent Arbitration Procedure is similar to the SDRM in various respects. Both call for a statutory mechanism without remarkable international bureaucracies or personnel and have very similar tools to address the central problems in bankruptcy. However, they are also different in critical respects.

In the FTAP, all creditors would be equal, whereas in Krueger the IFI continue to enjoy first priority on claims. The FTAP would not amend the powers of the IMF, the Fund would merely become one of the creditors. For Raffer, the undue preference of IFI in sovereign lending distorts incentives and yields less repayment to other

[109] See Krueger (2002c).

creditors. Just like any financial consultant, the IMF should be held accountable for its advice. The IMF presently continues to be a „*creditor in its own right and a judge in its own cause*", Raffer claims.[110] If the IMF always gets paid out first, the link between decision and risk is disturbed and market efficiency is severely damaged. Raffer would grant the Fund full participation in the procedure and notes that it could possibly provide technical assistance in bondholder co-ordination. It could also provide funding to sustain liquidity. New loans could then enjoy preferred status, as would all funds injected for the same reason. However, it should not attach them to presently enforced conditionality-requirements. IMF-lending under the FTAP would be unconditional.

Another difference between the FTAP and the SDRM lies in the scope of the debtor states the mechanism would effectively apply to. The FTAP wants to see arbitration used for all countries with unsustainable debt burdens, including HIPCs. The FTAP seems to envisage a number of cases for the beginning until all developing country debt is linked to a sustainable path. The SDRM in turn does not expect to solve all existing debt overhang and rather includes the motivation of solving future cases, especially emerging market debt problems. Krueger predicts a longer time period before the necessary changes in the Articles are adopted, and states that any new statutory mechanism would come too late for present cases. Moreover, the IMF is unlikely to be willing to see its efforts under the HIPC initiative undermined through interference in competence by an SDRM. In the IMF view, the two programs should merely be well co-ordinated.

It can be concluded that the FTAP addresses a number of crucial shortcomings in the international financial system as well as in the developing countries' political and economic landscapes. It is also quite accurate in criticizing various IMF policies. However, a number of issues the FTAP advocates are liable to be politically unrealistic or unfeasible to monitor and to execute succesfully. For one, the scope of powers the FTAP envisages for the international bankruptcy tribunal does not seem feasible at present. The concessions the creditors would make toward the debtor-state are certainly economically sensible in serious cases of overindebtedness. However, as long

[110] See Raffer (2002), p. 5.

as the creditor uncertainty on abuse of central elements of the FTAP is not effectively mitigated, it does not seem to have a chance to survive in a political debate.

Objections to an SDRM

Raffer criticizes Krueger's SDRM as only superficially restricting the IMF's decisive powers. For Raffer, the SDRM is still much too IMF-centered and not sufficiently transparent and participative. The IMF would remain in the position of endorsing a payments standstill. The Fund would also be the instance to determine debt sustainability, and judge the debtor's economic policies. „*As determining the sustainable level of debts means determining the necessary reduction of claims, very little substance would remain in those hands where it should be according to Krueger*".[111] Raffer is harsh in criticizing the IMF's claim to be the „*most effective channel…*" to reach decisions. He argues with a touch of sarcasm that the IMF has mostly not been able to put debtors on an economically sound basis and consequently, a high number of failures in IMF policies render further adjustment programs necessary. For Raffer, „*IMF-flops are securing IMF-jobs*",[112] and the insistence of the IMF on the implementation of its programs is grounded in institutional self-interest rather than good economics.

Substantial doubts remain among Raffer (2002), Taylor (2002), and Eichengreen (2002) that the SDRM de facto transfers the power to activate the standstill from the debtor government to the IMF. Granting more expansive powers to the IMF is likely to be regarded as adding to the uncertainty that already exists. It has also been criticized that creating an international agency to monitor and coordinate the process of renegotiation carries the danger of only adding to the bureaucracy (Eichengreen 2002). The need for a mediator may very well exist, as creditors and the debtor may not trust each other's determination to negotiate in good faith. Meanwhile, according to these critics, there is no persuasive argument why creditors and debtors would not be able to appoint a mediator on their own on an ad hoc basis.

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111 See Raffer (2002), p. 2.
112 See Raffer (2002), p. 4.

4.6.2. Expected Policy

Official Sector

Following the strong contractual case made by the US Treasury together with acrimonious voices from the markets, Krueger approved the primary feasibility of CACs in spite of their shortcomings. The most important benefit of CACs is that they can be put faster into working. For all their shortcomings, Krueger is convinced that at the end of the day a statutory underpinning is going to be necessary (Krueger 2002c). The contractual approach, much along the lines of the Taylor-proposal, is now the first „track" of a twin-track approach and is designed to provide the acid test for new sovereign debt policies. If CACs do the job, that could be the end of the story. Yet if they do not, the second and complementary track involves creating the SDRM.

The US Treasury and the IMF appear to become the decisive players in policy-making for a reform in sovereign debt restructuring processes. The IMF's Board of Directors also supports an SDRM (although details remain open). The impact of other international players, especially the EU, should not be ignored. In any case, the degree to which the EU members (mostly represented individually) will have effective powers depends on their success to join forces and speak with one voice. The EU has not initiated any proposal of its own, but has nonetheless shown the way in one respect: it has recently agreed on collectively including CACs in all EU-member's bond contracts issued under foreign jurisdictions.[113] Hopes are alive that the example of the EU will move European emerging market countries (e.g. Poland, Hungary) to adopt CACs in the foreseeable future. Taylor of the US Treasury has repeatedly confirmed his active support for contractual reform, however simultaneously keeping the options open for further action (i.e. SDRM) if deemed necessary.

Markets

Without the approval of international financial actors, reform is unlikely to be a success. Fortunately, one might think, there has been some support for an orderly

[113] See Taylor (2002b), p. 1.

approach for sovereign bankruptcy from an association representing foreign bondholders, as seen in this statement:

> *""During the autumn of last year, a conference of jurists and public men of various countries ... [discussed] ... the possibility of international agreements upon the principles of law which should determine the liability of sovereign states and foreign subjects in their relations to one another. ... There can be no question as to the advantage that would result from such an agreement."*[114]

If only this quote from the annual report of the Corporation of Foreign Bondholders was dated 2002 and not 1874. Today, one is unlikely to hear such statements from major market actors. There are a number of opponents of reform among international financial professionals who see no need, or rather no feasibility, to do anything more than to show more resolution and not to throw official money into emerging market problems.[115] The argument is largely along the following lines: „*When both debtors and creditors have negotiated constructively in good faith, negotiations have been quick to produce results. Creditors have been capable to form representation committees when things have gone seriously wrong. And in cases where the debtor has not simply declared default and restructuring a fait accompli (as in Russia 1998 and Ecuador 1999), creditors have honored the co-operation.*“[116] If warnings about the difficulties of market-based restructurings were disregarded and the IMF together with the financial community showed more „backbone“, a healthier system would be self-executing. The architects of a new bankruptcy procedure are thus claimed to be preoccupied with a non-problem.

Faced with the determination of the official sector and largely failed „more backboned“ policies of the IMF and the US treasury (see Argentina), markets have generally come to accept CACs to some extent. They threaten to embrace CACs in sovereign bond contracts only if plans for a SDRM are abolished. Markets seem to hope that the SDRM will fall either through its "own weight" or in the US Congress (where US policy is decided on). Single voices from the markets have already joined the proposal-game by submitting their own versions of CAC-approaches.[117] The Emerging Markets Trading Association (Chamberlin 2002) set out two principles for CACs in

114 Annual report of the Corporation of Foreign Bondholders (1874) in Krueger (2002d), p. 1.
115 See e.g. Roubini (2002), Chamberlin (2002), Porczecanski (2002).
116 Roubini 2002, p. 8.

order for them to be acceptable. First, the clauses must be "marketable" in the sense that they must be acceptable by the marketplace of creditors and debtors. Second, to the extent that the clauses make bonds easier to restructure, they should not also make defaults and/or restructurings more likely.

5. Conclusion

5.1. Final Assessment: Centralized or Decentralized Approach?

The contractual solution appears to be the most prudent and feasible first step. If the IMF and G-7 governments push for the inclusion of CACs in the Argentine debt that will eventually have to be restructured, they could effectively enforce their use as a precondition for international support. The problem is still likely to remain that the restructured Argentine debt is going to enter the market with remarkable spreads, which in turn is not going to encourage other emerging market officials to adopt CACs free of influence.

In the light of the functional complementarities, one could go from speaking of statutory vs. contractual approaches to calling them the centralized vs. decentralized approach.[118] In other words, it is not so much about contracts or statutes anymore as these are likely to be intertwinned and complementary anyway, but more about where decisions are made. In order for the SDRM to resemble the ambitious CAC approach, the following criteria must be met. First, the SDRM should encourage early creditor participation and provide incentives for negotiations instead of a blueprint for restructuring waiting in Washington (or anywhere else). Secondly, the most important decisions affecting creditors should not be made by the SDDRF but by a qualified majority of the creditors themselves. It is important that the SDRM only provides a broad framework. The preservation of an essentially voluntary and market-based atmosphere is vital for the success of the system. In the end, any mechanism will be as effective as creditors and debtors want it to be. Also, the IMF's implicit role in an

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[117] One of them envisages a majority action clause set at 95%, requirements of timely information delivery for the debtor as well as negative pledge covenants previously not included in CACs. See Debevoise (2002), p. 3.
[118] Terminology used by Taylor (2002b) and Miller (2002) among others.

SDRM may still be suspiciously broad. Given that agreement can be reached on the issue of IMF-discretion in the new SDRM, it seems difficult to be strongly in favour of ambitious CACs, implicitly acknowledging that collective action is an important issue, and at the same time to strongly oppose the current SDRM.

5.2. The Real Challenge

First, the effective scope of a bankruptcy procedure should be clear. What countries would a new sovereign bankruptcy procedure effectively help? For the sake of argument, restrict the motivations for bankruptcy procedures to two central aspects: collective action problems among creditors and the debtor's fresh start from insolvency. For middle-income countries with multiple creditor classes, the collective action problem is probably the more crucial and complex one. For HIPCs, the fresh-start aspect is certainly the more relevant aspect. The problem to be mitigated in the their case is an enormous debt trap from which they will not recover without substantial debt write-down. However, a bankruptcy procedure in the HIPC case will presumably not be enough. The case of developing country debt overhangs will have to be discussed in a much larger context of an overall development assistance strategy beyond the scope of this paper, as well as beyond the scope of an SDRM.

Second, it is always possible to find a growth rate of GDP that is high enough for a country to become solvent at some point. When this is the central issue, then the entire institutional tinkering around an SDRM or CACs still do not adress the real problems. Indeed, a great part of the underlying problems discussed in this paper lie in the policies and institutions of the debtor countries impeding economic development. The attempts by the international community (mainly the World Bank & IMF) to foster economic development with conditionality provisions in lending have neither been very succesful. A number of issues in the international economy are in the need of reform. If for example, trade liberalization is to foster economic growth, it needs to be a true „liberalization" and allow for a positive transfer of resources to the developing world, eventually allowing growth and economic prosperity to materialize. It has not been within the scope of this paper to discuss all developing country policies in any appropriate detail and trace their inefficiencies in complex sets of ideological, political or cultural realms.

Third, why not get radical? The Bulow (2002) approach is one that achieves a solution which is less concerned with institutional tinkering but carries a long-term perspective. In the simple Bulow-world of complete sovereign immunity, only governments with sustainable economic policies would be receiving foreign capital. The Bulow-approach does bring considerable problems in the short and middle run that may even hinder it from ever becoming policy. But its eventual message hits the real problem: Let countries borrow as much as they want and see how creditors react! If this works, international sovereign lending would be radically guided by quality providing a real incentive for good policy efforts. The Roubini (2002) critique on Bulow is also correct. None of the past sovereign debt crises was directly a sovereign debt crisis and to that end, eliminating the sovereign immunity waivers would not have directly addressed the problem. At the same time, it is certainly legitimate to ask what an SDRM could have done better. Left alone, presumably not much at all. Even the most recent case of Argentina that motivates so many contributions to submit a proposal to the "save-the-world-financial-game" could presumably not have been prevented with the SDRM alone. The path towards solutions lies much rather in the two measures identified as parts of the broad strategy in the Bulow approach: Eliminate the biase toward debt finance and keep the IFI out of bailouts. Both provisions are certainly easier proposed than implemented.

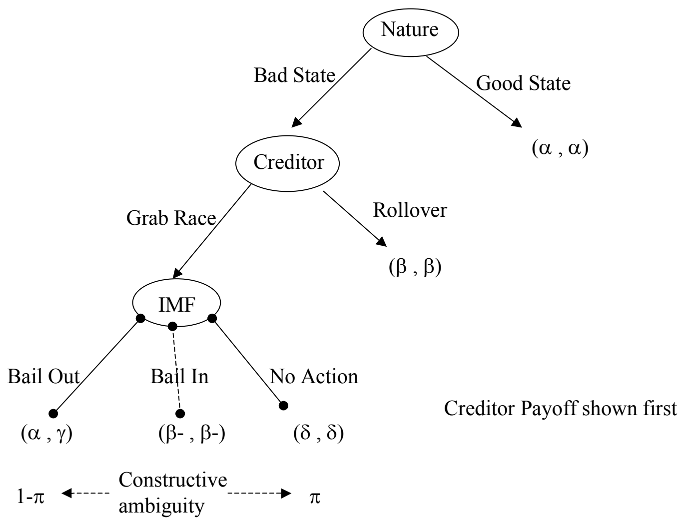
Nevertheless the chances of CACs or the SDRM should not be written off too early. Whether the world settles for CACs or one day in the future builds up an SDRM-like mechanism, the central objective should be clear: A succesful new sovereign bankruptcy procedure should provide a well-defined and predictable process that contributes to more certainty. An SDRM, given that it is broad in coverage, transparent in the process as well as unambigous and impartial in judgement is a step forward in this matter. Developing complex mandates that are intransparent in decision-making and leave room for broad discretion can cure symptoms but not the disease. When drafting bankruptcy procedures for sovereigns, one can certainly learn from basic provisions of domestic bankruptcy legislation. Yet the sovereign case entails a complex set of problems, be they in political and legal enforcement or simply in cultural interpretation. Sovereign bankruptcy will never equal domestic bankruptcy, and in the end one cannot, and should not, try to rule out the pain of bankruptcy. In the moment that repudiation is painless, the bonding role of debt is undermined. This applies to sovereign states even more as it does to corporations. Much rather, the international community should try to move to a superior stance where pain poses a credible threat, yet is canalised to hurt along the principles of market efficiency.

A. Annex

A.1. Time Inconsistency and Two Solutions[119]

For the sake of argument, ignore all existing doubts on IMF policy and take IMF action for an indispensable remedy for the global financial system in the event of crisis, i.e. no action by the IMF yields the worst outcome for all parties involved. The dangers of this time consistency trap become apparent when looking at the game theory behind this setting in more detail. The basic intuition of this action can be illustrated in a game played by the IMF-plus-debtor and the creditor. To simplify, the IMF plays the role of itself and the debtor in one. Let nature define whether the state of an economy is "Good" or "Bad".

Figure 2.1. The time consistency trap and two proposals



Source: Miller (2002), p. 8

In this figure, $\alpha > \beta > \beta- > \gamma > \delta$ holds. In the "Good" state the game is short as everyone wins, everyone is happy with a flourishing economy (debtor receives α) and high investment returns (creditor receives α). However, in the "Bad" state where the

[119] See Miller (2002), p. 4-6

debtor defaults, the creditor has the first-mover advantage, he can either "Grab" or "Rollover". If the creditor rolls over the debt, both parties get β. A grab race by the creditor and a bailout by the IMF yields α for the creditor and γ for the IMF-plus debtor. The default payoff is δ for both. If the creditor chooses to rollover, no action is required by the IMF and the second-best equilibrium materializes. But when the tree is worked backward, the result under rational expectations reasoning is that the creditor chooses to grab. Suppose the IMF refuses to act. Looking at the game, this clearly neglects the order of play after a bad state of nature has emerged. The IMF is forced to bailout, since this outcome is strictly superior to doing nothing ($\gamma > \delta$). The creditor knows this and therefore never agrees to rollover.

Solutions

1. The strategy of **constructive ambiguity** is a mixed strategy, where the IMF chooses "No action" with probability π and "Bailout" with probability $(1-\pi)$. The creditor has an incentive to rollover, as long as expected payoff is less than β, i.e. $(1-\pi)\alpha+\pi\delta<\beta$.
2. The option of a **bail-in** can be illustrated in the game tree between "Bail out" and "No Action". Through an appropriate debt-write down the payoff for the creditor is less than under rollover, but since the payoff for IMF-plus-debtor is higher in case of bail-in than under bailout, the creditor will choose to bail-in.

A.2. Lender of Last Resort (LOLR) vs. the IMF[120]

1. Bagehots (1873) LOLR lends freely. The IMF cannot lend freely because it can run out of money (it is just a financial intermediary).
2. Bagehots LOLR lends unconditionally. The IMF currently imposes ex-post conditionality. To function by clearly set rules, the conditionality would have to be *ex ante* in nature. Under the present system of "discretionary eclecticism", the IMF cannot install preconditions and lend truly freely to everyone fulfilling them (See e.g. Tarullo 2001).

[120] See also IFIAC (2000)

3. Bagehots LOLR lends with penalty rates. IMF lending is often perceived as subsidized (moral hazard). This point is discussed and empirically hard to test because one has to predict future repayments.
4. Bagehots LOLR lends on good collateral. The IMF has no de jure force in its member countries. Some however argue that ex-post conditionality serves as quasi-collateral (Cornelli/Felli 1995).

B. Abbreviations

CAC	Collective Action Clause
FSIA	Foreign Sovereigns Immunity Act (USA)
FTAP	Fair and Transparent Arbitration Procedure
IDRA	International Debt Restructuring Agency
ILLR	International Lender of Last Resort
IMF	International Monetary Fund
LOLR	Lender of Last Resort
MAC	Majority Action Clauses
NGO	Non-Governmental Organisation
SDDRF	Sovereign Debt Dispute Resolution Forum
SDRM	Sovereign Debt Restructuring Mechanism

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World Bank Group at www.worldbank.org