

SOVEREIGN DEBT AT THE CROSSROADS

Challenges and Proposals for Resolving the Third World Debt Crisis

Edited by

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DEALING WITH SOVEREIGN DEBT: TRENDS AND IMPLICATIONS

Arturo C. Porzecanski

The history of international finance is littered with instances of governments that declared themselves unable to meet their financial obligations on a timely basis. For example, it has been documented that Spain defaulted on its debt 13 times from the sixteenth through the nineteenth centuries, a period during which France defaulted eight times and Portugal and Germany (or rather, its predecessor states) did so a half dozen times. Latin American governments defaulted frequently during the 1800s, not just the 1900s. Turkey and its predecessor, the Ottoman Empire, were often in default during the nineteenth and twentieth centuries (Reinhart et al. 2003).

This chapter provides an overview of the reasons behind sovereign debt defaults. It discusses trends in external indebtedness (public and private) and in government indebtedness (domestic and foreign). It describes the manner in which private lenders and investors, and official bilateral and multilateral agencies, have dealt with sovereign defaults during the 1980s and 1990s. And it closes with an in-depth consideration of the case of Argentina post-2001, which promises to be the most complex sovereign default and workout in contemporary history.

The main arguments are, first, that private lenders and investors have been, and continue to be, able to deal promptly and effectively with instances of sovereign default, such that new, supranational bankruptcy procedures are not necessary. Second, official lenders have not proven to be similarly capable of coping with and resolving instances of sovereign overindebtedness, and thus they should not be relied upon to play an even larger role in the international financial architecture. And third, Argentina's lingering debt woes are not the result of shortcomings in market practices or international norms but rather stem

largely from that country's self-inflicted wounds and from its government's ideological unwillingness to negotiate a practical solution.

Reasons for Sovereign Defaults

Events of sovereign default have clustered around times of armed conflict, political upheaval, or global economic distress—times during which governments incurred deficits they could not finance because economic activity and public confidence were disrupted. World Wars I and II, the Great Depression, the oil price shocks of the 1970s, and the collapse of the Soviet Union all gave rise to economic and political stresses that paved the way to sovereign defaults. Moreover, defaults have often followed the abandonment of rigid exchange-rate regimes, be it the various gold standards typical of the 1800s and early 1900s or the managed currency regimes that were prevalent in the emerging markets until the 1990s. Governments with a poor track record, little credibility, and limited political resolve—especially when their own financial woes were aggravated by widespread corporate and bank failures—have been particularly susceptible to default (figure 13.1).

Governments tend to default specifically when they must increase spending quickly (for instance, to prosecute a war), experience a sudden shortfall in revenues (because of a severe economic contraction), or face an abrupt curtailment of access to bond and loan financing (e.g., because of political instability). It is usually very difficult for governments in such trouble to take the necessary offsetting actions, such as hiking tax collections or cutting spending on an emergency basis, and governments generally do not have the deep cushion of cash

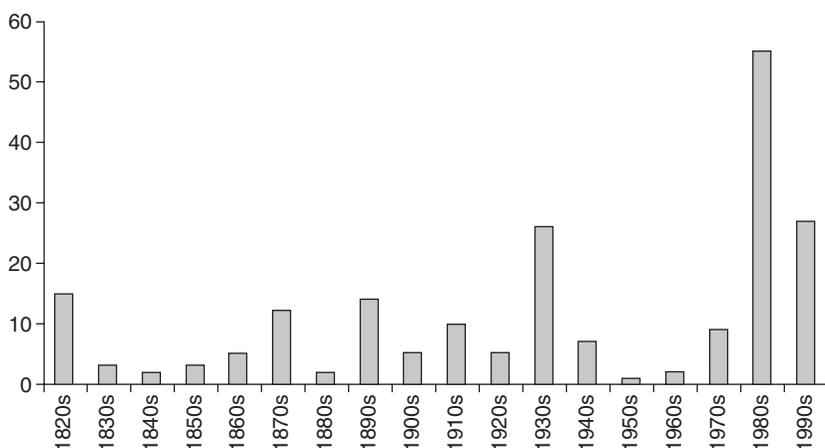


Figure 13.1. Number of government defaults declared on foreign-currency debt. Source: Standard & Poor's, *Sovereign Defaults: Heading Lower into 2004*, 18 September 2003, pp. 15–17.

reserves that could allow them to forestall a default. The sudden exit from a given currency regime, for its part, can lead to a default because the typically large currency depreciations that follow often generate confidence crises that reduce the demand for government bonds and money, generating inflation and capital flight. The resulting spike in domestic interest rates and bond yields sometimes scares rather than entices investors and lenders to provide funds to the government out of concern that a “debt trap” will soon exhaust the authorities’ capacity or willingness to keep servicing their obligations. Governments with large exposures to currency mismatches and interest rate or maturity risks are, of course, particularly vulnerable.

The governments that have defaulted during the past three decades have had a more burdensome public debt in relation to current revenues and GDP, a higher proportion of external debt in relation to total indebtedness, and a shallower domestic financial market than those that have not defaulted (IMF 2003a). The much-quoted ratios of public or external debt to GDP often do not convey the degree of vulnerability of a sovereign to default risk because a great deal depends upon the currency denomination, floating-rate nature, and maturity structure of the liabilities.¹ The creditworthiness of governments with a high proportion of debts in or indexed to hard currencies (e.g., U.S. dollars, euros, or Japanese yen) is dependent upon the exchange value of their local currency, such that a sharp depreciation can seriously undermine their ability to pay or even refinance obligations. The finances of sovereigns that issue debt indexed to inflation, or sell bonds with floating or adjustable coupons, are similarly vulnerable to a sudden rise in inflation or hike in market interest rates. Governments that place mostly short-dated securities are exposed to refinancing or liquidity risks—even if they are otherwise creditworthy (Porzecanski 2004).

The unreliability of debt-to-GDP ratios explains why they correlate less well with the risk classifications assigned to sovereigns by the credit-rating agencies than do the ratios of government debt to revenues, especially given the wide range of ratios present in each creditworthiness category. The credit ratings awarded by Fitch Ratings (see table 13.1) and Moody’s Investors Service, for example, are consistent with a multiplicity of debt ratios—and especially debt-to-GDP comparisons.

Trends in External Indebtedness

The focus of most media coverage, academic research, and policy studies has been on defaults involving the external indebtedness of nations. This indebtedness consists of the financial obligations of the government and the private sector to foreign lenders and investors. Defaults on the external debt of governments have usually but not always caused the private sector to default on its own foreign indebtedness. Sometimes causality has run the other way, with private-sector bank or corporate defaults, or near defaults, affecting the government’s own wherewithal. In any event, it is estimated that at least two-thirds of the total external indebtedness of developing countries consists of government obliga-

TABLE 13.1 Government debt ratios by Fitch sovereign rating categories^a

	Debt as % of GDP		Debt as % of revenues	
	Average	Range	Average	Range
<i>Investment grade</i>				
AAA	44.5	6–68	109.8	12–168
AA	45.2	0–150	108.1	0–514
A	36.5	5–105	148.4	13–239
Chile	36.5		148.4	
BBB	38.7	15–61	125.5	40–238
Malaysia	45.6		197.5	
Mexico	45.6		202.1	
Poland	47.5		123.2	
South Africa	38.0		125.5	
<i>Noninvestment grade</i>				
BB	48.6	18–81	222.2	74–528
Bulgaria	53.6		146.7	
Colombia	55.1		196.1	
Peru	46.7		274.8	
Philippines	70.0		497.7	
Russia	42.4		113.5	
B/C/D	79.8	22–181	301.5	95–825
Argentina	166.7		934.8	
Brazil	85.7		227.3	
Ecuador	62.8		242.1	
Turkey	90.9		337.9	
Venezuela	57.2		273.3	

^aGeneral government debt ratios for 2002, sovereign ratings as of September 2003.

Source: Fitch Ratings, *Sovereign Data Comparator*, 30 September 2003, p. 6.

tions, whether to official creditors (bilateral or multilateral agencies) or private creditors (foreign banks, bondholders, and suppliers). This proportion has not changed much since the 1970s.²

The total external indebtedness of developing countries (figure 13.2 multiplied very rapidly during the 1970s and then quadrupled between 1980 and 1998 when measured in current U.S. dollars, but it has stabilized since then at about \$2.6 trillion (IMF 2004, p. 228). In relation to rising exports of goods and services, this external indebtedness has diminished from the equivalent of 1.7 times in 1998 to an estimated 1.2 times as of 2003. As will be seen, however, the decline has been much smaller, or nonexistent, in relation to GDP.

Once broken down by region, it is apparent that the trends are quite dissimilar. On the one hand, the external indebtedness of African countries has fallen since 1995 in nominal terms (see table 13.2) by 9%, or a cumulative \$27 billion (U.S.), and especially in relation to total exports and GDP—mainly the combination of debt forgiveness on the part of official and private creditors and constrained access to international capital of any sort. At the other extreme, the

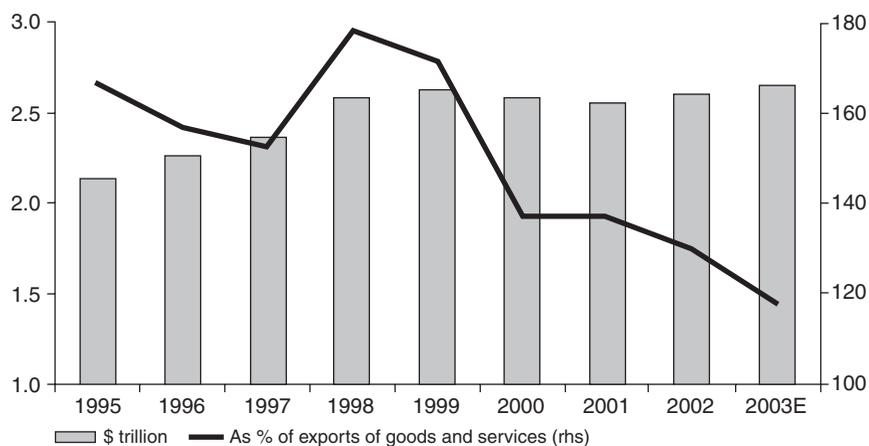


Figure 13.2. External indebtedness of emerging markets. Source: IMF, *World Economic Outlook*, September 2003 (Washington, DC: IMF, 2003), pp. 228–29.

external indebtedness of Eastern European and former Soviet Union countries has grown most rapidly in absolute terms (by almost 55%, or \$155 billion) since the mid-1990s, declining relatively little in relation to export earnings. The foreign debt of Asian developing countries has grown in nominal terms (by 18%, or \$106 billion) during this time but has dropped quite markedly in relation to both exports and GDP—to ratios that are rock bottom, in fact. The foreign debt of the Asian countries is now equivalent to less than 77% of export earnings and to a mere 25% of GDP, whereas the respective averages for all emerging markets are close to 118% (exports) and 38% (GDP).

In the Middle East, the increase in external indebtedness has been meaningful (by 38%, or \$139 billion) since 1995, but an impressive reduction in ratios to

TABLE 13.2 Absolute size of external indebtedness by region

	\$ Billion (U.S.)			Change 1995–2003	
	1995	2000	2003E	\$ billion	%
Africa	295.3	272.8	267.9	–27.4	–9.3
Developing Asia	577.5	673.9	683.8	106.3	18.4
Middle East and Turkey	369.5	493.9	508.9	139.4	37.7
Latin America	622.3	761.3	758.6	136.3	21.9
Emerging Europe ^a	282.9	384.0	438.5	155.6	55.0
Total	2,147.5	2,585.9	2,657.7	510.2	23.8

^aCentral and Eastern Europe, Russia, and former members of the USSR.

Source: IMF, *World Economic Outlook*, p. 228.

export earnings and GDP has nevertheless been achieved. Latin America registers more indebtedness (\$136 billion) but a mixed result in terms of its burden, with good progress relative to export performance but not in terms of GDP. The reason is that currency depreciations and economic stagnation were common in many South American countries during 1999–2003, reducing the U.S. dollar value of their economic output. Nevertheless, Latin America's foreign debt is still by far the highest in relation to export earnings (nearly 210%)—double the ratios prevailing in both emerging Europe and the Middle East, and nearly triple the ratio in developing Asia—and is quite burdensome when compared with GDP as well (above 40%) (table 13.3).

It is noteworthy that the maturity profile of the foreign debt has been improving, with long-term indebtedness accounting for nearly 90% of the total as of 2003, up from 85% in 1995. The improvement is most dramatic in Asia and Latin America, where governments learned the hard way in 1997–98 that too much short-term debt can precipitate a liquidity crisis even in otherwise creditworthy countries. With regard to the degree of reliance upon the private capital markets, the regions show a remarkable disparity. Whereas on average the developing countries rely upon private sources for around 60% of their total external financing, the range varies from a low of 25% in the case of African

TABLE 13.3 Characteristics of external indebtedness by region

	% of exports of goods and services			Difference 1995–2003E	% of GDP			Difference 1995–2003E
	1995	2000	2003E		1995	2000	2003E	
Africa	249.4	174.2	151.1	–98.3	72.1	63.0	49.2	–22.9
Developing Asia	126.9	96.3	76.9	–50.0	32.6	30.7	25.3	–7.3
Middle East and Turkey	172.9	146.8	136.4	–36.5	58.5	59.2	54.8	–3.7
Latin America	253.2	212.3	208.1	–45.1	36.9	38.7	44.1	7.2
Emerging Europe ^a	110.4	115.1	96.4	–14.0	N/A	N/A	N/A	N/A
Total^b	166.6	137.2	117.6	–49.0	41.5	40.6	37.7	–3.8

	Long-term debt (% of total)			Difference 1995–2003E	Owed to private creditors (% of total)			Difference 1995–2003E
	1995	2000	2003E		1995	2000	2003E	
Africa	90.7	93.3	93.1	2.4	28.8	25.2	25.0	–3.7
Developing Asia	81.5	90.9	90.6	9.1	57.6	56.8	56.4	–1.1
Middle East and Turkey	88.4	87.1	90.1	1.7	53.4	65.7	63.6	10.1
Latin America	84.8	87.6	87.2	2.5	69.0	78.3	72.9	3.9
Total	85.4	89.3	89.6	4.2	56.0	62.6	59.9	3.9

^aCentral and Eastern Europe, Russia, and former members of the USSR.

^bTotals of debt to GDP exclude the countries of Emerging Europe because of the unavailability of comparable data.

Source: IMF, *World Economic Outlook*, pp. 229–233.

countries to a high of 73% in emerging Europe and Latin America. Debt of countries in emerging Europe to official sources used to account for nearly half of the total. Now it represents less than one-fourth of the total. Reliance on private sources of financing has also increased meaningfully in the Middle East (up from less than 53% in 1995 to 64% in 2003). The African countries have been notoriously dependent upon concessional aid from official bilateral and multilateral agencies, and so have a number of poor countries in South Asia. It is interesting that the regional average for Asia is little changed despite the graduation of several countries in East Asia from reliance upon financing from foreign official agencies.

Trends in Government Indebtedness

Trends in external indebtedness do not tell the whole story, however. In the past decade, governments in most emerging markets have allowed for, and often fostered, the development of local bond markets.³ In Latin America, for example, the development of bond markets has followed from the partial (or, in the case of Chile, wholesale) privatization of pension regimes and also from the growth of other financial intermediaries such as mutual funds and insurance companies. The emergence of private pension funds and private insurance companies, in particular, has created a natural demand for long-term assets such as government and corporate bonds. The fact that, during the 1990s, Latin American governments and central banks managed to vanquish hyperinflation and stabilize their currencies has encouraged these institutional investors to purchase bonds. Initially, most government and corporate bonds were denominated in U.S. dollars or else their principal was adjusted by the cost of living, and they all had short maturities. Increasingly, however, domestic bonds are being denominated in the local currency, bear a fixed interest rate, and feature lengthening maturities.

In other parts of the world, such as in East Asia and Turkey, governments have been turning for funding to local banks or, in the wake of massive bailouts, they have recapitalized domestic banks by issuing government bonds to them, which count as subordinated debt. Considering the number of bad experiences involving reliance on external indebtedness, it should not be surprising that many governments have increasingly chosen to meet more and more of their financing needs domestically—albeit often at higher cost and with shorter maturities, at least initially.

As noted at the start, however, external-debt data include the foreign liabilities of both the public and private sectors, but many times they do not evolve in a similar manner—nor do they suffer the same fate in the event of great economic or political stress. In the wake of the 1997–98 financial crisis, for example, many banks and corporations throughout East Asia have been paying off the bulk of their external obligations.⁴ This has generally not been the case in Latin America. In emerging Europe, in contrast, there has been a quantum leap in private-sector foreign indebtedness—starting from next to nothing, of course,

before the 1990s. Therefore, it is worthwhile to separate out trends in the foreign debt of governments from trends in the cross-border liabilities of banks and corporations.

Regional variations are again considerable. In the Asian developing countries, domestic government indebtedness has increased most rapidly—by nearly 20 percentage points of GDP between 1995 and 2002—such that the average ratio of domestic debt to GDP stood at around 45% by 2002. Latin America follows with an increase worth some 12 percentage points of GDP during the same seven-year period, to a regional average debt-to-GDP ratio of almost 25%. In the Middle East and Africa, domestic government indebtedness has risen from 35% to a heavy 41% of GDP. In emerging Europe, in contrast, there has been a relative drop in domestic indebtedness, such that the regional ratio has fallen from 30% to 21% of GDP. On an unweighted regional average basis, domestic government debt has increased from 21% to 30% of GDP since the mid-1990s (see table 13.4).

The foreign debt of governments has tended to increase relative to GDP in Asia and in Latin America, such that total public indebtedness now exceeds the equivalent of 60% of GDP, up from less than 45% of GDP in the mid-1990s. In the countries of the Middle East and Africa, government foreign debt has decreased marginally relative to GDP, and given the aforementioned rise in domestic indebtedness, the overall liability position of governments has worsened slightly to around 94% of GDP—an exceedingly high ratio, indeed, for countries with a usually low revenue base. In the sample of emerging European countries, the cross-border obligations of governments have dropped off substantially as a proportion of GDP, following mostly successful economic transformations that have boosted per capita incomes, mirroring the trend in domestic debt. Consequently, the burden of public debt in that region has plunged since 1995 from the equivalent of 80% to 55% of GDP. All regional trends considered, emerging-market governments are more indebted, both domestically and abroad, than they were in the mid-1990s (see figure 13.3).

TABLE 13.4 Domestic and external government debt (% of GDP)

	Domestic			External			Total		
	1995	2000	2002	1995	2000	2002	1995	2000	2002
Developing Asia	25.5	42.1	44.1	17.0	23.0	22.1	42.5	65.1	66.2
Latin America	12.1	17.5	23.7	30.2	26.7	36.8	42.3	44.2	60.5
Middle East and Africa	34.9	40.7	40.9	55.3	48.7	53.1	90.2	89.4	93.9
Emerging Europe	30.3	17.0	21.1	49.5	41.2	33.6	79.8	58.3	54.7
Total^a	21.4	26.7	30.3	37.2	33.2	36.0	61.4	64.5	71.4

^aUnweighted regional averages; the domestic and external debt subcomponents do not sum to the total for all emerging markets because only countries for which continuous data were available are included.

Source: IMF, *World Economic Outlook*, p. 116.

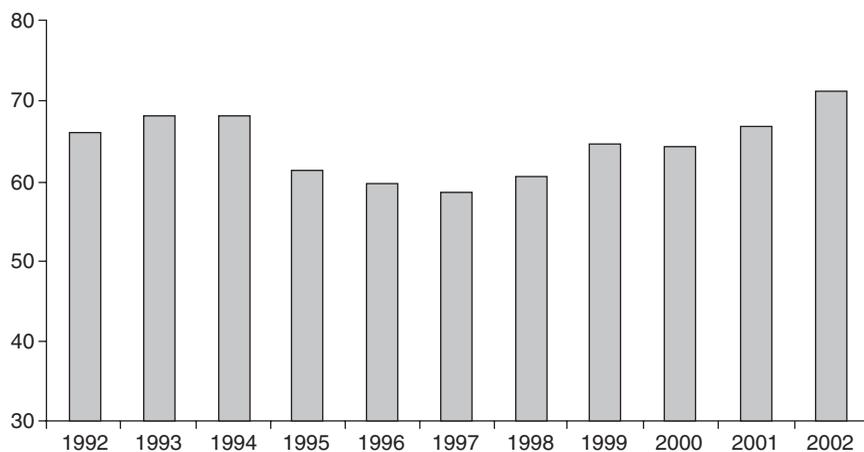


Figure 13.3. Government indebtedness in emerging markets (% of GDP). Source: IMF, *World Economic Outlook*, p. 17.

The rise in domestic government indebtedness relative to GDP witnessed in all regions with the exception of emerging Europe raises the issue of whether future defaults might not affect mostly domestic rather than international investors. An examination of the pattern of defaults since the mid-1970s suggests that instances of default involving foreign-currency debt have been far more numerous than those involving local-currency obligations (see Figure 13.4). Furthermore, the 1980s leap in events of default involving foreign obligations was not accompanied by a noticeable increase in domestic debt defaults from their low base.

At first sight, the impression is that governments respect their domestic financial obligations more than they do their international obligations. It is no wonder, therefore, that local-currency government bonds tend to be rated higher than foreign-currency bonds. Yet in a few countries where runaway domestic government debt is potentially the main source of financial instability, at least one of the major rating agencies (Moody's) has been awarding a lower grade to the local debt obligations of governments such as India, Japan, and Turkey.

To be sure, the globalization of financial markets means that foreign investors are increasingly purchasing domestic government debt, whether denominated in local currency or indexed to inflation or to the exchange rate, as opposed to bonds payable in hard currencies and subject to contracts under European or U.S. law. By the same token, domestic investors—from wealthy individuals to mutual and pension funds—are frequent buyers of their country's international bonds because they afford greater liquidity, legal protection, and other benefits, such as anonymity and tax sheltering. Therefore, it is difficult to conclude that even if sovereign defaults were to affect just one category of indebtedness, they would have an impact on but one group of investors.

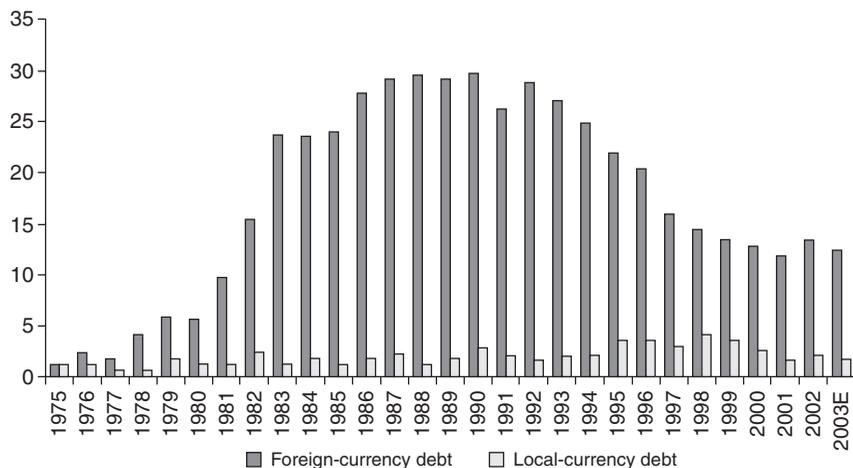


Figure 13.4. Incidence of sovereign defaults on foreign-currency and local-currency debt (% of all sovereigns). Source: Standard & Poor's, *Sovereign Defaults*, pp. 4–5.

Moreover, governments tend to shun defaults on domestic debt because they can have devastating consequences for banks, pension funds, and insurance companies, triggering a major destabilization of the domestic financial system. It is in any case much easier for governments to lean on domestic institutional investors to roll over or purchase additional public debt, either through moral suasion, raising liquidity requirements, or altering the investment criteria that pension funds must observe. Governments can also declare a default on foreign obligations while appealing to nationalism without fear that the gunboats of old will arrive to collect, whereas defaulting on domestic obligations is much more likely to provoke a run on banks and a backlash among voters. All things considered, defaults on domestic government debt should continue to occur less frequently than defaults on international obligations.

The implication is that the sovereign debt defaults of the future will probably keep impacting cross-border lenders and investors, and go on involving—directly or indirectly—the official bilateral and multilateral lending agencies. Therefore, how best to deal with governments in default will likely remain a challenge to the international financial community, and the prevention and cure of said defaults will continue to be the subject of considerable academic, market, and policy debate.

Dealing with Sovereign Defaults: Proposals

Bankers and bondholders all over the world have been dealing with sovereign debt defaults for centuries. Yet policy makers in Washington and other G7 cap-

itals have been promoting the idea that the functioning of the world's financial markets must be improved by making it easier for insolvent governments to obtain debt relief from their foreign creditors (Rogoff and Zettelmeyer 2002).

Two high officials appointed in late 2001 made this project their top priority: Anne Krueger, first deputy managing director of the IMF, and John Taylor, then undersecretary for international affairs at the U.S. Treasury. Ms. Krueger's ideas were formalized into a detailed proposal for a statutory mechanism to facilitate the bankruptcy of nations—the so-called sovereign debt restructuring mechanism, or SDRM (Krueger 2002). This proposal has yet to gain the necessary political support among a number of governments, including that of the United States. Its earlier versions envisioned a powerful role for the IMF that would have allowed it to make decisions that limit creditors' rights. In the face of universal criticism from private-sector lenders and investors, the IMF's role was later toned down to the equivalent of the sole expert witness, whereby the IMF would pass judgment on how much debt any government could reasonably be expected to service. In this capacity, the IMF (and thus its G7 and other government shareholders represented on its board of directors) would have a procedural advantage. They would be in a privileged position to protect the claims of official bilateral and multilateral lenders by insisting that a greater-than-otherwise amount of debt relief be granted by private creditors.

Mr. Taylor's approach, on the other hand, involved the voluntary modification of bond contracts to include clauses facilitating changes in payment and other terms by a qualified majority of bondholders (Taylor 2002). The main idea is that every bond contract should designate a bondholder representative to act as an interlocutor with the sovereign debtor; require the sovereign to provide more key financial information to its bondholders; allow for a supermajority of bondholders to amend payment terms, now often requiring unanimity of consent; and include enforcement provisions that concentrate the power to initiate litigation in a single jurisdiction (Group of Ten 2002). These new clauses have become widely known as collective-action clauses (CACs), and although several already exist in bonds issued under English law, most new and outstanding bonds of emerging-market sovereigns are issued in other jurisdictions, such as New York and Frankfurt, where such clauses have not been customary.

Most emerging-market issuers and investors were initially reluctant to introduce CACs in new bond contracts for fear of signaling that they contemplate or countenance an eventual default. Besides, even if such clauses were introduced voluntarily in all new debt issues, the stock of outstanding bonds would still be governed by preexisting legal arrangements such that the practical effect of CACs would be marginal for years to come. Under strong pressure from the U.S. Treasury, however, the governments of Mexico and Brazil were persuaded in early 2003 to issue new bonds with CACs, and they were successfully placed with institutional investors at no measurable extra cost. Governments such as those of South Africa, South Korea, and Venezuela followed suit later in the year, although each new sovereign bond tended to include its own particular clauses, meaning that a uniform market standard in CACs is yet to develop.⁵ On

the whole, nearly half of all new sovereign bonds (measured by value) issued in 2003 under New York law included CACs, whereas none of them had done so the previous year (Koch 2004).

In contrast with G7 and IMF policy makers, most institutional investors and lenders feel that any international reforms should focus on making contracts easier to enforce and facilitating the constructive involvement of bondholders and other private-sector creditors in debt-restructuring negotiations (IIF 2001b). Yet the G7 has not called for any actions or penalties against irresponsible governments, such as the attachment of their official international reserves when they are on deposit with central banks such as the U.S. Federal Reserve or with the Bank for International Settlements (BIS), the central banks' central bank. Thus, the investors who have filed suits and won judgments against Argentina in New York and other jurisdictions, because of the default that took place there starting in December 2001, cannot get their hands on the billions of dollars that the government of that country has sheltered at the BIS.

Although various proposals for resolving debt crises have been advanced, they all suppose that the lack of collective action among private-sector lenders and investors is the main obstacle to the smooth functioning of the international financial system.⁶

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

Dealing with Sovereign Defaults: The Record

The absence of innovative mechanisms has not impeded several landmark work-outs of sovereign indebtedness. The governments of Ecuador, Pakistan, Russia, and Ukraine, for example, have all been able to restructure their bonded debt—and have done so in record time. Substantial debt-service relief and even sizable debt forgiveness have been obtained through the use of exchange offers, often accompanied by bondholder exit consents that encourage the participation of as many investors as possible in take-it-or-leave-it settlements. Rather than amending bond covenants, the exchange offers typically entail the debtor government presenting its private creditors with a menu of voluntary options, such as accepting new bonds for a fraction (for example, 60%) of the principal owed but paying a market interest rate, or new bonds for the original principal but paying a concessional interest rate. Experience has demonstrated that neither the threat of litigation nor actual cases of litigation have obstructed these debt restructurings, which have involved large institutional investors as well as small retail investors throughout the world (World Bank 2003a).

For example, in early 2003, the government of Uruguay asked local and

international investors to consider a debt-restructuring request, and more than 90% of them agreed, enabling the operation to be consummated in a matter of several weeks.⁷ The Uruguayan authorities previously spent many months debating the nature of the restructuring with the IMF. The IMF wanted Uruguay to default on its obligations to bondholders as Argentina had done at the end of 2001, with the intention of likewise demanding massive debt forgiveness from private creditors, but the Uruguayan authorities refused to go down this potentially ruinous path. The government there wanted to pursue instead a market-friendly debt exchange with the sole purpose of stretching out the maturities falling due in 2003 and the next several years while respecting both the original amounts owed and the initial coupons. It was only after the Uruguayan authorities sought and obtained support from the Federal Reserve and the U.S. Treasury that the IMF staff backed down and agreed to support a voluntary debt exchange.⁸ Once an understanding between the IMF and Uruguay was reached, matters moved quickly. Informal discussions with private creditors were held in March 2003, a concrete proposal was put forth in April, investor replies were received in May, and by June Uruguay's bonded debt had been successfully restructured. This was accomplished despite the fact that the investor base was diverse and scattered around the globe: from retail investors in Argentina and Japan to institutional investors in the United States and Europe, all of whom were bound by contracts written in several jurisdictions, each with its own currency and distinct legal features. In the wake of the successful restructuring, Uruguay's debt rallied strongly, and before six months had passed, the government was able to return to the international capital markets, placing a new bond issue in October 2003 and subsequently other bonds in 2004 and 2005.

Historically, countries in financial trouble have followed one of three routes.⁹ The first is the negotiated route, whereby governments sit down to hammer out a debt-restructuring deal with a representative committee of either bondholders or commercial bankers, depending on which group holds a majority of the claims on the sovereign. This is the typical approach followed by dozens of governments from Argentina in the early 1980s to Vietnam in the late 1990s. They all negotiated with a bank advisory committee (BAC), or so-called London Club (because most of the negotiating sessions took place either in London or in New York), in contrast with the so-called Paris Club of official creditors (which meets under the aegis of the French Treasury). The BAC would then recommend to other private creditors that they accept the terms agreed to with the government in question, and most would usually do so (Rieffel 2003). Those unwilling to participate (e.g., small regional banks) would generally be paid but with the understanding that they would not be welcome to do new business in that country.

The second route is the unilateral exchange offer, whereby governments engage one or more commercial or investment banks to consult privately with a critical mass of lenders or investors about the possible shape of an acceptable settlement, which is then crafted and presented to all creditors on a take-it-or-leave-it basis. As mentioned previously, these exchange offers are accompanied by bondholder exit consents that encourage the participation of as many inves-

tors as possible by leaving nonparticipants in a disadvantageous position, for example, with less liquid securities. This is the approach that has become more popular and was used successfully by Pakistan (1999), Ecuador (2000), Ukraine (2000), and Uruguay (2003).¹⁰ In recognition that the ideal should not become the enemy of the good, governments will then, if necessary, quietly pay off any recalcitrant creditors when their original claims come due.

The third route is the unilateral demand, whereby a government comes up with a proposed restructuring on the basis of what it feels it can pay going forward—no matter that it may not be what the market will bear. There are few instances of this approach, but the precedents are not promising because the absence of a negotiated solution tends to lead to international financial isolation and also to prompt litigation, which can be successful in eventually securing payment in full.

The best example is Peru during the 1980s. In 1984, a round of debt negotiations between the government and its bankers failed, the country imposed restrictions on the use of foreign exchange to prevent the depletion of its international reserves, and this led to the accumulation of arrears. A year later, in 1985, newly inaugurated president Alan García stated that he would not negotiate with bankers and the IMF and that the government would pay in debt service the equivalent of no more than 10% of export earnings, or about \$300 million (U.S.) per year. At the time, interest arrears were already worth \$500 million, and debt-service payments due in 1985 exceeded 50% of expected export earnings. García's government ended up authorizing payments equivalent to some 20% of export earnings for a while but then stopped making any payments at all.

Having been in partial arrears to the IMF since September 1985, Peru was declared ineligible for further IMF funds in August 1986 and was later threatened with expulsion from the organization (Boughton 2001). The government ended up in arrears not just to private creditors but to virtually all official creditors, including the Inter-American Development Bank (IADB) and the World Bank. Many of Peru's commercial lenders filed lawsuits to preserve their legal claims because they worried that, if they did not do so, the statute of limitations would expire on the outstanding debts.

In 1990, after Alberto Fujimori was elected Peru's new leader, the country's economic policies and attitudes changed radically for the better. President Fujimori initiated a major market-friendly reform of the economy and adopted sound fiscal and monetary policies agreed to with the IMF, though initially without the benefit of new loans. Beginning in late 1991, the government paid off its arrears to the IADB, IMF, and World Bank with bridge loans provided by Latin American, the Japanese, and the U.S. governments, paving the way for debt relief from the Paris Club and resumed lending from the IMF and other multilaterals. Meanwhile, the authorities switched to a negotiated approach with private creditors, convening a bank advisory committee and signing an agreement to stay all pending lawsuits to promote negotiations to resolve the entire problem of unpaid foreign debts. The country would eventually (in 1997) complete a debt-restructuring process under the Brady Plan, becoming current with

all creditors. However, after pursuing a claim in U.S. courts for several years, a lone disgruntled creditor (*Elliott v. Peru*) was able to obtain full payment in 2000 on a small amount of unstructured obligations after posing a credible threat of attachment to payments made by the government to Brady bondholders.¹¹

The case of Peru illustrates that when a sovereign is willing to negotiate a realistic debt-relief formula in good faith, in the context of efforts to improve its capacity to service post-restructuring obligations, then the overwhelming majority of private lenders and investors can be persuaded to accept some losses and move on. In contrast, official lenders are very unwilling to grant debt forgiveness and often even to reschedule maturing obligations. The multilateral agencies, in particular, deem themselves to be preferred creditors who must be paid in full at the originally contracted interest rates and maturities no matter the circumstances. They claim that because they are willing to lend to governments in trouble when private lenders are not, they should receive top priority in the chain of payments. And yet, the lending programs of the multilaterals to governments cut off from the international capital markets are often insufficient to cover even the obligations coming due to the agencies themselves. Besides, all disbursements are highly conditional on stabilization policies and structural reforms, such that funds arrive in installments with many strings attached. The foreign aid and export credit agencies, for their part, are usually so slow to grant any debt relief that governments in dire need often start running arrears to them in the hope that those payments will be restructured down the road—and eventually, they usually are.

The cases of Bolivia, Nicaragua, and Ecuador, with which this author had some involvement, highlight the difference between how private and official creditors have treated governments in serious financial trouble.¹² In 1988, commercial bank creditors first forgave nearly 90% of what the government of Bolivia owed them, and in 1993 they wrote off nearly 85% of the then-remaining principal (IIF 2001a).

In contrast, the country became eligible for debt relief from official bilateral and multilateral creditors under the original heavily indebted poor countries (HIPC) initiative a full decade later, in September 1998, and under the enhanced HIPC initiative only in June 2001 (World Bank 2003b).

In 1995, commercial bank creditors forgave more than 90% of what the government of Nicaragua owed them. In contrast, official bilateral creditors represented by the Paris Club canceled less than 70% of the eligible debts at about the same time, with no debt relief coming from the multilateral agencies. The country never became eligible for debt relief under the original HIPC initiative, although Paris Club creditors agreed to cancel 70% of Nicaragua's remaining debt obligations in December 2002.¹³ The country finally qualified for the comprehensive debt-forgiveness benefits of the enhanced HIPC initiative in early 2004.

In 1995, private creditors also granted a mix of debt and interest forgiveness to the government of Ecuador as part of a comprehensive Brady-style settlement. Creditors accepted the choice of either writing off 45% of the principal owed

while stretching out the maturity dates for repayment of the remainder for thirty years, or charging highly concessional interest rates for thirty years. The holders of nearly 60% of the total debt chose to provide principal relief, and the remainder chose to provide long-term interest-rate forgiveness.

When Ecuador experienced acute economic difficulties again in 1999, the IMF made it clear to the government that it would not get any help from the official community unless it defaulted to private creditors and obtained debt forgiveness once again.¹⁴ Shut out of IMF and other official financial support, the government had no choice but to declare default even though very small amounts were coming due on outstanding Brady and Eurobond debt.¹⁵ Before long, Ecuador's bondholders were formally requested to grant permanent debt relief—and by August 2000 they had forgiven about 40% of what was owed to them.

In contrast, official bilateral and multilateral lenders have not granted any debt forgiveness to Ecuador. The country was twice deemed by the IMF to be insolvent enough to deserve write-offs from private creditors—but not poor enough to deserve write-offs from the official development community. Paris Club creditors therefore have agreed merely to reschedule about one-third of debt-service payments coming due (those originally maturing between May 2000 and May 2001 and between March 2003 and March 2004) according to the Houston terms, the least generous of all Paris Club poor countries' debt treatments. This means that Ecuador has continued to be charged mostly market interest rates by its official creditors and is expected to repay the bulk of its obligations when they come due.¹⁶

Meanwhile, it is still business as usual at the multilateral agencies: They have not rescheduled, never mind forgiven, any of Ecuador's debt, and they have provided little new money. In fact, from 2000 to 2002, amortization payments by Ecuador to the multilateral agencies exceeded disbursements from those agencies (IMF 2003b). Once interest payments made to the multilateral agencies are factored in, it becomes clear that Ecuador has made substantial net transfers to the official community.

In conclusion, bondholders and commercial and investment banks in Japan, Europe, and the United States should be recognized rather than castigated for their track record in dealing with sovereign debt problems. They have helped to resolve expeditiously and even generously the sovereign debt crises in which they have been involved in various parts of the world. Official bilateral and multilateral agencies, on the other hand, cannot make a similar claim, even though they are charged with fostering development and the alleviation of poverty conditions. The insistence of multilateral creditors on the sanctity of originally contracted amounts and payment terms combined with their highly conditional and often modest new lending, plus the unwillingness of bilateral creditors to make substantial concessions quickly, means that official lenders are often part of the problem rather than part of the solution. This is true in the case of the poorest countries in the world, and it is also true in the case of Argentina.

The Case of Argentina: Background

The international financial community is currently witnessing the aftermath of the largest sovereign debt default in contemporary history—that declared by Argentina in late December 2001. It has involved nearly \$90 billion (U.S.) of mostly bonded debt plus more than \$20 billion in overdue interest payments through the end of 2004. The default was declared at a time when the country had lost the confidence of its domestic and international investors. Deposits had been withdrawn from the banking system on such a large scale that a freeze on deposits was imposed, the refinancing of even a small amount of maturing domestic government debt had become nearly impossible, and the IMF had refused to keep providing emergency financial support.¹⁷

During the 1990s, Argentina's capacity to service its debt obligations became inextricably tied to the peculiar exchange-rate regime adopted in early 1991 and ditched officially in January 2002 whereby the value of its currency (the peso) was set equal to that of the U.S. dollar. The public debt had grown during the 1990s for a variety of reasons (such as deficit spending by the central and provincial governments, massive bond issuance to settle old liabilities, and losses incurred by the central bank) from the equivalent of less than 35% of GDP in the early part of that decade to over 50% of GDP by 2001. The one-to-one regime encouraged the government, and also the private sector, to take on mostly foreign-currency-denominated debt. By late 2001, in fact, only 3% of the total public debt, and a mere 2% of total government bonds, were denominated in Argentine pesos (figure 13.5), whereas more than 70% of obligations were contracted in U.S. dollars and the remainder in other hard currencies.

This extremely skewed currency composition of the public debt represented a huge potential risk because when one peso was equal to one dollar, the public debt was roughly equivalent to some 50% of GDP, as noted, but if ever one peso (ARS) no longer purchased one dollar (USD), then the country's debt ratios

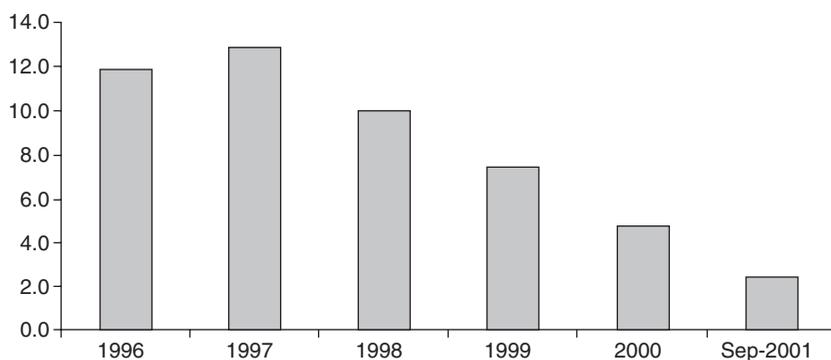


Figure 13.5. Argentina: government bonds denominated in local currency. Source: Argentina Ministerio de Economía y Producción.

would instantly spiral out of control. At an exchange rate of 2 ARS/USD, the burden of the mostly foreign-currency-denominated public debt would double to the equivalent of about 100% of GDP, and at 3 ARS/USD it would balloon even more to an unviable 150% of GDP.¹⁸

How could a government that collected tax revenues only in pesos, that had long ago sold all of its assets that could attract dollars, and that was legally prevented even from printing pesos—the then-autonomous central bank was authorized to issue pesos only in exchange for dollars—end up with only a token amount of its liabilities denominated in pesos? And yet, this patently irresponsible currency mismatch, which was overlooked by the financial markets and was blessed by the IMF, with which Argentina maintained a very close working relationship throughout the 1990s, ensured that if there was ever a change in the currency regime involving a major devaluation, the public sector would be rendered instantly insolvent.¹⁹

To lighten the government's debt burden and also that of most households and corporations in the face of a deepening economic depression, the incoming administration of President Eduardo Duhalde passed an Economic Emergency Law in early January 2002 forcibly converting most obligations denominated in U.S. dollars into Argentine pesos at one-to-one parity. A decree issued in February of that year further ruled that bank deposits would be converted into pesos at a more favorable exchange rate of 1.4 ARS/USD and that the government would issue bonds to the banks to compensate them for the mismatch of having their assets and liabilities converted at different exchange rates. New measures announced that March offered bank depositors the option of receiving government bonds in exchange for frozen deposits and specified that all government debt issued under Argentine law would be converted into pesos at the more favorable 1.4 ARS/USD rather than at 1:1. Shortly thereafter, the Central Bank of Argentina issued regulations making it clear that debts related to foreign trade transactions, future and forward contracts, or governed by foreign law were not subject to any conversion and remained denominated in U.S. dollars.

The results of these measures were that most Argentine debtors were sheltered from the financial impact of the peso's devaluation and that bank depositors obtained partial compensation for the currency's slide, though their deposits could not be withdrawn at will. At the other extreme, multinational corporations were impacted very adversely by the peso's devaluation because the bulk of their liabilities were to parent companies and other cross-border lenders and investors and had to be serviced at the new, heavily depreciated exchange rate. To add insult to injury, all companies—mostly multinationals—rendering public services (e.g., providers of electricity, telecommunications, and water) were barred from raising their prices during 2002–03, and were granted only modest rate relief during 2004–05.

Commercial banks, the largest of which are mostly foreign-owned, were impacted adversely in various ways. By mid-2005, they had received government bonds in full compensation for the the losses caused by the asymmetric conversion of assets and liabilities from USD into ARS. They had not been compensated by the value of deposits that were paid out in full, in USD or its ARS

equivalent at the new exchange rate, under court orders obtained in 2002–04 by many depositors. And they faced a yield mismatch that resulted in heavy operating losses during 2002–03 stemming from the fact that many of their assets (e.g., government bonds and personal and mortgage loans) pay low interest rates indexed to inflation or wages, whereas many of their liabilities (deposits that are no longer frozen) pay higher, market-based interest rates. As a result, most of the banks operating in Argentina in 2005 remain financially vulnerable and undercapitalized.

The financial condition of the government initially improved somewhat as a result of the conversion of some of its obligations from dollars into pesos, but it soon deteriorated significantly because of the issuance of substantial amounts of new debt to banks and their depositors. Therefore, excluding arrears of principal and interest, the stock of public debt, which had amounted to the equivalent of \$144 billion (U.S.) at the end of 2001, dropped to \$113 billion by end of March 2002 but proceeded to increase thereafter and by the middle of 2003 had reached \$153 billion, the equivalent of more than 120% of GDP. Once arrears were included, the public debt stood at approximately \$185 billion by the end of 2003 (table 13.5), which represented about 140% of that year's GDP. By the close of 2004, the public debt had further increased to over \$190 billion due to accumulation of interest arrears, but because of the economy's strong recovery, this was equivalent of about 125% of that year's GDP.

TABLE 13.5 Argentina: Public sector debt (U.S.\$ billions, 2003E)

	Principal	Past-due interest and other arrears	Total	% of total
<i>To be restructured</i>				
Bonds	81.2	18.2	99.4	53.7
Loans	6.8	0.5	7.3	3.9
Bilateral agencies	4.9	0.4	5.3	2.9
Commercial banks	1.6	0.1	1.7	0.9
Other creditors	0.3	0.0	0.3	0.2
Subtotal	88.0	18.7	106.7	57.6
<i>To be excluded from restructuring</i>				
Bonds	30.6	0.0	30.6	16.5
Guaranteed	10.0	0.0	10.0	5.4
Other (BODENs)	20.6	0.0	20.6	11.1
Loans	47.9	0.0	47.9	25.9
Guaranteed	14.6	0.0	14.6	7.9
Multilateral agencies	30.8	0.0	30.8	16.6
Other	2.5	0.0	2.5	1.3
Subtotal	78.5	0.0	78.5	42.4
Total	166.5	18.7	185.2	100.0

Source: Argentina Ministerio de Economía y Producción. Available online at: www.mecon.gov.ar/finance/sfinan/reest-deuda/road-show-cwg-oct-03.pdf.

During the course of 2002–03, the governments of President Duhalde and his elected successor, Néstor Kirchner, made it clear that whereas about two-fifths of debt obligations would be honored under certain conditions, the remainder would not be paid pending a restructuring that had to involve a massive amount of debt forgiveness. The senior debt being serviced, with a face value of nearly \$80 billion (U.S.), consists of the new bonds issued mainly to banks and their depositors (the so-called BODENs); new bonds and loans guaranteed by tax revenues resulting from a distressed-debt exchange in late 2001; and old and new loans from the multilateral agencies (the IMF, Inter-American Development Bank, and World Bank). However, the Duhalde and Kirchner governments let it be known that debts to these official agencies would only continue to be serviced if the agencies themselves started disbursing new loans in amounts equivalent to what was coming due.²⁰ The junior debt in arrears, with a face value of over \$90 billion, is made up largely of bonds issued in various foreign jurisdictions, plus a small amount of loans from official bilateral agencies and private-sector commercial banks, all dating from before the end of 2001.

The Case of Argentina: Prospects and Implications

The restructuring of Argentine government debt has posed a complex and daunting challenge to the international financial community. Beyond the fact that no other sovereign had defaulted on so huge a volume of indebtedness, there was the sheer dimension of the task at hand. According to the authorities, the securities they wished to restructure encompassed more than 150 individual bond issues denominated in seven different currencies and subject to eight distinct governing jurisdictions.²¹ Moreover, it was estimated that almost 45% of the debt up for restructuring was in the hands of hundreds of thousands of scattered individual investors, mostly in Italy and Germany. This was a departure from the norm, which is that a few dozen institutional investors (e.g., mutual and pension funds, insurance companies, and commercial and investment banks) account for the vast majority of debt to be restructured. Therefore, the legal and ownership features of the Argentine case promised to make any debt restructuring particularly difficult to achieve.

To make matters worse, the Argentine authorities made it known that they aimed to obtain a massive write-off. At the unveiling of their initial proposal during the IMF/World Bank annual meetings in Dubai in September 2003, they requested that 75% of eligible principal and 100% of past-due interest be forgiven. At follow-up meetings that took place in Europe and the United States during October 2003, they further proposed issuing new bonds with coupons as low as 0.5% per year and with maturities as long as 42 years (Argentina Ministry of Economy and Production 2003). This implied degree of desired relief, on the order of more than 90% on a net-present-value basis, has no parallel in the country's checkered financial history, which includes defaults in the nineteenth century but no interruptions of debt servicing during the nearly 90 years until 1982.²²

Indeed, the combination of principal, interest rate, and maturity relief desired by the Argentine government was only comparable with—and for the most part exceeded—that sought by the poorest countries in Africa and Latin America during restructurings that took place in the 1980s and 1990s. The threshold of pain that the authorities proposed to inflict on bondholders was very difficult to justify given the country's relative income and wealth. Indeed, as of 2003, per capita income in Argentina stood at an estimated \$3,400 per year, temporarily depressed in the wake of the massive currency devaluation of 2002 from its usual level of \$6,000–\$8,000 per year. Even so, the depressed figure put the country in a league far above that of the poorest countries in Africa and Latin America, where per capita incomes hover around \$1,000 per year or less. Not surprisingly, most investors willing to be quoted reacted very negatively to the initial Argentine proposal.²³

The extraordinary degree of debt and debt-service forgiveness sought by the Argentine authorities was derived by calculating unilaterally a maximum fiscal effort deemed to be sustainable politically and economically. This effort is measured by the so-called primary fiscal surplus, namely the excess of current revenues over current and investment outlays before consideration of interest payments. The higher the primary fiscal surplus, the more nonborrowed resources are available to meet interest payments on the public debt—and to possibly amortize some principal as well.

According to the authorities, a primary fiscal effort equivalent to 2.4% of GDP (figure 13.6) for the federal government, plus an extra 0.6% of GDP generated by provincial governments, is all that was compatible with fostering an economic recovery with GDP growth averaging 4% per year during 2004–06. By Argentine standards, the proposed primary fiscal effort was meaningful, because this measure averaged 0.5% of GDP during 1994–2002. However, other

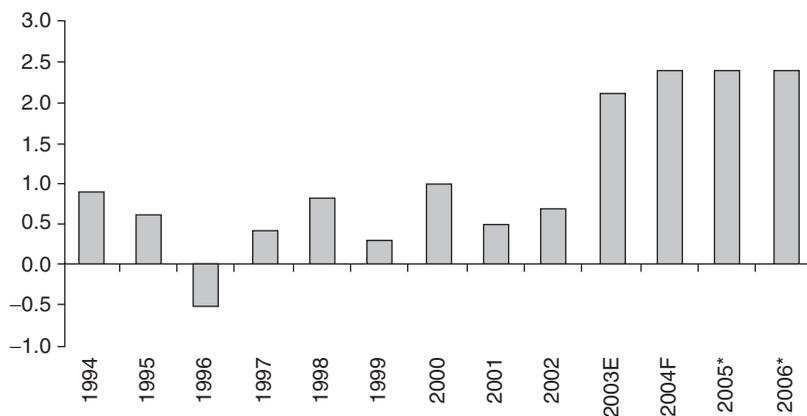


Figure 13.6. Argentina: primary fiscal balance (% of GDP). Source: Argentina Ministerio de Economía y Producción.

countries in similar straits have pledged to make, or have been making, even greater fiscal efforts, on the order of 4–6% of GDP (e.g., Brazil, Ecuador, Turkey, and Uruguay) to minimize the degree of otherwise necessary debt forgiveness. Therefore, many creditors were unlikely to find acceptable the fiscal effort that the Argentine authorities envisioned.

The desired extent of debt relief was also shaped by unilateral calculations of debt sustainability, namely the necessary improvement in key solvency ratios such as debt to GDP and annual debt service to fiscal revenues. This improvement was designed to enable Argentina to obtain upgrades in its rock-bottom sovereign credit ratings and renewed access to the international capital markets in the not-too-distant future. According to official projections, even assuming that the debt restructuring proceeded as intended, that the multilateral agencies refinanced all of Argentina's maturing principal repayments during 2004–13, and that the government could place new bonds domestically to offset the scheduled redemption of performing debt, there would be a meaningful residual financing gap in every year starting in 2005 and at least through 2010. Therefore, while the government was aiming to come back to the capital markets as quickly as possible after the debt restructuring was completed, experience from the African and Latin American governments that had previously obtained debt forgiveness anywhere near the magnitude that Argentina was expecting showed that they had not been able to return to the international financial markets.

Beyond the many obstacles to a prompt and successful restructuring of Argentina's obligations, there is the matter of how the government proceeded in terms of a negotiating strategy. The Kirchner administration has pursued a confrontational, unilateralist approach that is reminiscent of Peru's Alan Garcia. It has not been willing to negotiate in good faith with its creditors, and the assumptions behind its proposal for massive relief have been widely questioned.²⁴ After the government put forth a finalized bond exchange proposal in early 2005 seeking debt relief on the order of a less extreme 70% on a net-present-value basis, it was accepted by three quarters of bondholders—a sizeable majority, to be sure, but by far the smallest acceptance rate of any sovereign debt-restructuring exercise, which has usually exceeded 95%. As of this writing, nearly four years after declaring a default, Argentina was ignoring its holdout creditors with claims potentially worth some \$25 billion (U.S.), and it had not yet approached official foreign aid and export-credit agencies, and other commercial lenders, with any kind of debt restructuring proposal.

The ultimate outcome need not be the same, of course. Whereas it took more than a dozen years of relative isolation for Peru to clear its payments arrears to all official and private-sector creditors, it could well take less time for Argentina to regularize its international financial relations. However, chances are that litigation now making its way in European and U.S. courts, and other individual and class-action lawsuits yet to be filed, will complicate any eventual attempted return to the world capital markets. Several investors have won court judgments against Argentina of which EM Ltd., led by Kenneth Dart, who was successful in taking on Brazil when that country went through its Brady bond restructuring,

is the largest with a \$724 million ruling in its favor courtesy of the U.S. District Court (for the Southern District of New York).

The fact is that distressed-debt investors, including vulture funds, have been attracted to defaulted emerging-market debt, buying paper (bank loans, supplier credits, or bonds) with the intention of suing for full recovery. According to Singh (2003), most of these investors have been successful in their litigation or in forcing out-of-court settlements, or are holding favorable judgments and orders of attachment (table 13.6). They have averaged recovery rates of about three to 20 times their investment, equivalent to returns net of legal fees (often recouped from the sovereign) of 300–2,000%. However, litigation is a protracted affair in which many lawsuits take between three to ten years to settle. Sovereigns are exposed to the greatest vulnerability when they make or receive payments through existing systems such as Euroclear and Clearstream, as evidenced by the cases of *Elliott v. Peru* and, more recently, *LNC Investments v. Nicaragua*. Therefore, there is a risk that by failing to reach a friendly understanding with virtually all of its creditors, any funds that the Argentine government may attempt to obtain in the future in the international capital markets may be attached by disgruntled or opportunistic bondholders.

Does the case of Argentina suggest that the international financial architecture has proved to be deficient? Our answer is decidedly in the negative. Different rules of international financial engagement would not have avoided the traumatic

TABLE 13.6 Recent cases of litigation against sovereigns

Debtor	Face value of claim	Outcome
Brazil	\$1.48 billion (U.S.)	Paid in full
Cameroon	ECU3.8 million	Partial attachment; attempted retrial
Cameroon	\$19.9 million (U.S.)	Under appeal
Congo	\$27 million (U.S.)	Settled for 30% of face value
Congo	\$7 million (U.S.)	Settled
Cote d'Ivoire	\$10 million (U.S.)	Settled
Ecuador	\$6 million (U.S.)	Paid in full
Ethiopia	\$100 million+ (U.S.)	In arbitration
Guyana	\$6 million (U.S.)	In arbitration
Honduras	\$1.7 million (U.S.)	Not settled
Madagascar	\$55 million (U.S.)	Paid in full
Nicaragua	\$96 million (U.S.)	Attempting to attach assets
Panama	\$48 million (U.S.)	Settled
Peru	\$64 million (U.S.)	Paid in full
Poland	CHF5 million	Settled
Turkmenistan	\$3.8 million (U.S.)	Paid in full
Uganda	\$5.5 million (U.S.)	Ordered to pay \$20.6 million (U.S.)
Uganda	\$1.8 million (U.S.)	Ordered to pay \$2.7 million (U.S.)
Uganda	\$10.5 million (U.S.)	Ordered to pay creditors
Yemen	\$8.2 million (U.S.)	Settled for 1/3 of face value
Zambia	\$45 million+ (U.S.)	Settled for \$100 million (U.S.)

Source: Singh (2003).

exit of a heavily indebted and currency-mismatched government out of an artificial exchange-rate regime, and they would not hasten the country's financial rehabilitation.

Specifically, the existence of a supranational SDRM back in 2001, or the presence of CACs in all of the country's bonds, would not have made matters any easier. Because a substantial proportion of the Argentine government's debt obligations was held by local banks, pension funds, and insurance companies, any announcement of a payment standstill with the intention of seeking meaningful debt forgiveness via an SDRM or the activation of CACs would surely have triggered a stampede of bank depositors for the exits and a collapse of the pension and insurance industries. This would have led to a run on the central bank's official reserves, rather quickly precipitating a devastating currency devaluation, the imposition of limits on bank withdrawals and capital outflows, and thus the same economic implosion, political fallout, and popular discontent that was witnessed in late 2001 and early 2002. Those who believe that Argentina could have defaulted, obtained debt forgiveness, and returned to "business as usual" in no time at all—if only the government could have trampled on the rights of investors protected by foreign law as easily as it trampled on those operating under its own laws—are engaging in wishful thinking.

All debate regarding the extent of debt forgiveness that was appropriate for Argentina to receive would likewise not have been avoided—not without adverse consequences, in any case—by the existence of an SDRM or the widespread application of CACs. In either case, a debtor government must still persuade the vast majority of its creditors to accept a proposed debt-relief formula. We doubt that bondholders would have accepted the kind of massive debt forgiveness that the Argentine government requested in September 2003 or thereafter, even if the SDRM had been operational and the IMF had given the Argentine demand its full blessing.

It is true, however, that individual creditors would find it still more difficult to collect from an errant government such as Argentina's if it were under the protection of an SDRM-administered restructuring plan. But if creditor rights were curtailed relative to the status quo compliments of an investor-unfriendly reform of the international financial architecture, surely Argentina would not be able to come back to the capital markets for a very long time, and other weak sovereign credits would lose their present-day level of access to international private capital. Argentina would probably become a ward of the official multilateral agencies—the ones that are already heavily exposed there, have been bullied by the government into making substantial new loans, and cannot possibly be objective about how much debt forgiveness the country is entitled to obtain from junior creditors.

As considerable experience has taught, only international and domestic reforms that strengthen rather than weaken the enforcement of contracts, and that encourage dialogue and cooperation rather than the imposition of unilateral "solutions," are likely to speed up the rehabilitation of countries in financial trouble. A highly complex sovereign debt restructuring such as Argentina's can only be handled by a meeting of the minds between the government and its mostly

private-sector creditors, accomplished either through face-to-face negotiations with a representative committee of bondholders or through an extensive, informal consultation process that leads to an acceptable exchange offer. These are the tried and tested avenues to eventual success.

The missing ingredient is willingness on the part of the Argentine authorities to help themselves. In the context of a negotiated solution to their over-indebtedness conundrum, this willingness would have translated into committing a greater share of rapidly rising tax revenues to future debt service and to using a portion of accumulating international reserves to make some up-front payments on account of past-due interest.²⁵ These are the kinds of concessions that many governments—Argentina’s and others—have made in past debt-restructuring negotiations in return for permanent debt forgiveness on the part of private lenders and investors. The alternative is a long, drawn-out “dialogue of the deaf” that will encourage more litigation and that has the potential to tie up in knots the implementation of the restructuring deal reached in early 2005 with the majority of creditors. A *deus ex machina* sovereign bankruptcy solution imposed by the G7 governments is not a realistic alternative.

Acknowledgments Two sections of this chapter draw heavily on material that appeared in “The constructive role of private creditors,” *Ethics and International Affairs*, 17: 2 (2003), 18–25.

Notes

1. An analysis of the ratios of external debt to GDP in the year when a default episode occurred shows that, at least during the 1980s and 1990s, many emerging-market countries experienced an adverse credit event despite the fact that their ratios were below 50% of GNP. See Reinhart, Rogoff, and Savastano, “Debt Intolerance,” pp. 11–12.

2. The World Bank estimates that the external debt of developing countries reached \$2.43 trillion (U.S.) as of the end of 2003, of which \$2.07 trillion, or 85% of the total, consisted of long-term government and government-guaranteed obligations, including the use of IMF credit. It is not known what percentage of the short-term external indebtedness of \$364 billion was owed or guaranteed by governments, but chances are that most of it was owed by private-sector banks and corporations. See World Bank, *Global Development Finance 2004*, 2 vols. (Washington, DC: World Bank, 2004), 2: 2.

3. The notable exception is Africa, where it is really only in South Africa that there is a thriving domestic bond market.

4. According to the World Bank, the long-term external indebtedness of the private sector in the East Asia and Pacific region was cut back from a peak of \$159 billion (U.S.) in 1998 to \$115 billion as of the end of 2003, and the region’s short-term external indebtedness, which involves mostly private-sector obligors, has been reduced from a maximum of \$132 billion in 1997 to \$63 billion as of the end of 2000, though it is estimated to have crept back up to \$112 billion by the end of 2003. See World Bank, *Global Development Finance*, 2: 6.

5. The Institute of International Finance (IIF), a Washington-based research and advocacy group that represents the world’s largest private financial institutions, was first to announce its support of CACs. However, it also called for the establishment of a private-sector advisory group to work with troubled debtors and the official community, and a

partnership between private financial institutions and governments to limit disruptive creditor litigation (see www.iif.com/data/public/icdc0402.pdf, 9 April 2002). The pursuit of such market-based approaches was later endorsed by five other private-sector organizations (Emerging Markets Creditors Association, Emerging Markets Traders Association, International Primary Market Association, Securities Industry Association, and The Bond Market Association; see www.emta.org/ndevelop/oneill.pdf, 3 June 2002). These industry representatives later went on to draft a set of model collective-action clauses that could be included in future bond contracts, but they took care not to weaken the rights of bondholders for the sake of expediency (see www.emta.org/ndevelop/Finalmerged.pdf, 31 January 2003). For a review of the application of CACs under New York law, see Sergio J. Galvis and Angel L. Saad, "Collective Action Clauses: Recent Progress and Challenges Ahead," 20 February 2004. Available online at: www.law.georgetown.edu/international/documents/Galvis.pdf.

6. According to the first deputy managing director of the IMF, a new approach to sovereign debt restructuring is needed because "in the current environment, it *may* be particularly difficult to secure high participation from creditors as a group, as individual creditors *may* consider that their best interests would be served by trying to free ride. . . . These difficulties *may* be amplified by the prevalence of complex financial instruments . . . which in some cases *may* provide investors with incentives to hold out . . . rather than participating in a restructuring" (emphasis added). See Krueger, *A New Approach*, and p. 8.

7. Cleary, Gottlieb, Steen, and Hamilton (U.S. attorneys for Uruguay). 2003. "Press release: Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring, 29 May 2003. Available online at: www.cgsh.com/newsworthy-categories.cfm?strNwsCatName=Restructurings.

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

9. There is a fourth approach followed by various French kings in the 1500s and 1600s—that of beheading the creditors—but thankfully it has gone out of style in recent centuries. See Reinhart, Rogoff, and Savastano, "Debt Intolerance," p. 8.

10. Interestingly, the government of Pakistan followed this route even though its bonds were governed by U.K. law and included CACs. Therefore, its obligations could have been amended after a negotiation process with the requisite qualified majority of bondholders.

11. Hedge fund Elliott Associates L.P. paid \$11 million (U.S.) in 1996 on the secondary debt market to buy \$21 million of Peru's sovereign debt and then sued for full repayment plus capitalized interest. The U.S. Court of Appeals eventually ruled in its favor, and it obtained enforcement orders from courts in several countries, including Belgium. It was the Brussels court's stance that discouraged members of Euroclear from accepting payments from the government of Peru on account of Brady bonds, which forced Peru to settle with Elliott by paying at least \$58 million. The individuals involved in Elliott Associates reportedly have conducted similar actions against several other sovereigns. For a discussion of the legal ramifications of such actions, see G. Mitu Gulati and Kenneth N. Klee, "Sovereign Piracy," 01-7 (2001). Available online at: http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID272194_code010604510.pdf?abstractid=272194.

12. The case of Russia, not detailed here, likewise illustrates these differences. Whereas private creditors agreed to provide substantial debt relief in early 2000, the Paris Club of official creditors only rescheduled a small amount of arrears and other payments coming due up to the end of 2000—some \$8 billion (U.S.) out of a total of \$51 billion of indebtedness to bilateral creditors represented by the Club. Available online at: www.clubdeparis.org/en/countries/countries.php?IDENTIFIANT=89&POSITION=0&PAY_ISO_ID=RU&CONTINENT_ID=&TYPE_TRT=&ANNEE=&INDICE_DET=.

13. Paris Club. 2002. Press release: The Paris Club and Nicaragua Agree to a Debt Restructuring under the Enhanced Heavily Indebted Poor Countries Initiative. 13 December 2002. Available online at: www.clubdeparis.org/rep_upload/PR01.pdf.

14. This is based on frank, off-the-record conversations with IMF and Ecuadoran officials. For the IMF's version of the events, see Stanley Fischer, "Ecuador and the IMF," 19 May 2000. Available online at: www.imf.org/external/np/speeches/2000/051900.htm.

15. After speaking to numerous IMF and Ecuadoran officials privately, another author concluded that "the IMF appears to have chosen to make Ecuador a guinea pig for a more aggressive approach to bailing in private creditors." See William R. Cline, "The Role of the Private Sector in Resolving Financial Crises in Emerging Markets," in *Economic and Financial Crises in Emerging Market Economies*, ed. Martin Feldstein (Chicago: University of Chicago Press, 2003), p. 482.

16. Paris Club. 2000. Press release dated 15 September 2000. Available online at: www.clubdeparis.org/en/press_release/pagep_detail_commupresse.php?FICHIER=com9889887550; Paris Club. 2003. press release dated 13 June 2003. Available online at: www.clubdeparis.org/en/press_release/page_detail_commupresse.php?FICHIER=com10554999350.

17. For useful background on Argentina's economic woes, see Arturo C. Porzecanski, "Argentina: the Root Cause of the Disaster," *ABN AMRO Emerging Markets Fortnightly*, 24 July 2002, pp. 15–20. Available online at: www.nber.org/~confer/2002/argentina02/porzecanski.pdf; Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington, DC: IIE, 2002); Ricardo Hausmann and Andrés Velasco, "Hard Money's Soft Underbelly: Understanding the Argentine Crisis," in *Brookings Trade Forum 2002*, ed. Susan M. Collins and Dani Rodrik (Washington, DC: Brookings Institution Press, 2003), pp. 59–119; Andrew Powell, "Argentina's Avoidable Crisis: Bad Luck, Bad Economics, Bad Politics, Bad Advice," in Collins and Rodrik (eds.), *Brookings Trade Forum 2002*, pp. 1–58; and Guillermo A. Calvo, Alejandro Izquierdo, and Ernesto Talvi, "Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons," in Alexander et al. (eds.), *Monetary Unions and Hard Pegs* (New York: Oxford University Press, 2004) pp. 151–181.

18. Once freed, the exchange rate jumped to as much as 3.86 ARS/USD in late June 2002 before settling at around 2.80–3.00 ARS/USD after March 2003. To be sure, the dollar value of GDP has since recovered somewhat, but as of 2003 the estimated value of Argentina's GDP (\$125 billion) remained a fraction of its predevaluation level (\$270 billion).

19. As the former chief economist of the IMF during the 1990s has admitted, "the Argentine case is particularly revealing because the Fund was deeply involved with Argentina for many years before the emergence of the present crisis. In this important respect, Argentina is different from most other cases where the Fund has provided exceptionally large financial support. . . . [The] failures of the Fund are clearly associated with the core of the Fund's most intense involvement with a member: when it is providing financial assistance and when the policies and performance of the member are sub-

ject to the intense scrutiny of Fund conditionality.” See Mussa, *Argentina and the Fund*, pp. 2–3.

20. To make this point crystal clear, in late 2002, the Duhalde administration briefly went into arrears with the World Bank, and in mid-2003 the Kirchner government briefly went into arrears with the IMF, when these institutions dragged their feet in terms of authorizing new disbursements. The Washington agencies, faced with the possibility of mounting arrears and potentially huge loan-loss provisions—and possibly massive write-offs down the road—quickly caved in and disbursed new funds to the government of Argentina in both instances, whereupon the government immediately cured its defaults to the multilateral agencies.

21. It is estimated that 53% of the obligations were denominated in U.S. dollars and 33% in euros, with the rest in other currencies, and that 51% of the debt was governed by U.S. law, 18% by English law and 17% by German law, with the rest subject to other jurisdictions including Argentina’s (11% of total). See Argentina Secretariat of Finance, Ministry of Economy and Production, “Argentina’s Restructuring Guidelines,” 22 September 2003. Available online at: www.mecon.gov.ar/finance/sfinan/reestr-deuda/dubai_22-9_english.pdf.

22. Argentina is one of the few countries of significance in Latin America that did not default during the Great Depression. For background on prior departures from fixed exchange-rate regimes and associated defaults or avoidance of defaults, see Gerardo della Paolera and Alan M. Taylor, *Straining at the Anchor: The Argentine Currency Board and the Search for Macroeconomic Stability, 1880–1935* (2001). For background on debt servicing during the Great Depression, see Erika Jorgensen and Jeffrey Sachs, “Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period,” NBER Working Paper #2636, June 1988. Available online at: www.earthinstitute.columbia.edu/about/director/pubs/w2636.pdf.

23. Agence France-Presse. 2003. Argentine Creditors Left Fuming with Debt Restructuring Proposal, 22 September 2003. Available online at: http://quickstart.clari.net/qs_se/webnews/wed/cu/Qargentina-debt-imf.RulU_DSM.html.

24. The Argentina Bondholders Committee (ABC) presented an alternative restructuring proposal in December 2003, and while it accepted most of the government’s assumptions, it demonstrated that a somewhat greater fiscal effort up front, and a greater willingness to roll over maturing obligations to domestic bondholders, could result in a drastically lower need for permanent debt forgiveness. See ABC, *Argentina Bondholders Committee Restructuring Guidelines*, 3 December 2003. Available online at: www.emta.org/ndevelop/ABC_Final_Restructuring_Guidelines_12-3-03.pdf.

25. In 2003, central government tax revenues jumped by 43% in peso terms and by 53% in U.S. dollar equivalents. See Argentina Secretaría de Hacienda, Subsecretaría de Ingresos Públicos. Available online at: www.mecon.gov.ar/download/rec_trib/2003-diciembre.xls. Official international reserves, for their part, increased by 35% in 2003 from \$10.5 billion (U.S.) to \$14.1 billion. See Banco Central de la República Argentina. Available online at: www.bcra.gov.ar/hm000000.asp.

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