

A Critique of Sovereign Bankruptcy Initiatives

THE IMF AND G7 SHOULD CURB FINANCIAL ASSISTANCE TO COUNTRIES IN TROUBLE.

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expressed here are solely his own.

Top International Monetary Fund (IMF) and U.S. Treasury officials have put forth proposals designed to make it eventually easier for governments and bondholders to go through a debt-workout process. Their intent is to enable the G7 governments to scale back their multi-billion-dollar bailout programs for countries in financial difficulty on the theory that, if the road to default was paved rather than bumpy, more of them would choose to take it rather than seek large-scale financial support. Experience strongly suggests, however, that the absence of better bankruptcy procedures has not impeded several debt workouts; that in cases when the bankruptcy option was available, it was nevertheless avoided; and that even if the IMF and Treasury initiatives had been in place in 2001, the tragedy in Argentina would not have been prevented. The best way for the G7 and the IMF to extricate themselves from the current morass is by curbing sharply the financial help that they offer to countries in trouble.

During the past year-and-a-half, policymakers in Washington and other G7 capitals have been advocating that the functioning of the world's financial markets must be improved by making it easier for insolvent governments, especially in the "emerging" markets, to obtain debt relief from their bondholders. Two high officials appointed in late 2001 have made this project their top priority: Anne Krueger, First Deputy Managing director of the IMF, and John Taylor, Under Secretary for International Affairs at the U.S. Treasury. In fact, the IMF's supervisory committee (the IMFC) has instructed the Fund's management to come up with a concrete plan for a statutory mechanism to facilitate the bankruptcy of nations by April 2003.

Official rationale and proposals

The IMF's rationale for this plan was summarized in a press release April 2002, issued after two days of Executive Board discussions on sovereign debt restructuring: "An important shortcoming in the international financial system is the absence of a framework for the predictable and orderly restructuring of sovereign debts. . . . The upshot . . . is that debt restructuring is often delayed, prolonged and disorderly, depleting asset values of creditors and imposing severe hardship on the debtor country. This is damaging not only to the debtor and its creditors, but it is also disruptive to international capital markets and to the trading partners of the debtor country."¹

According to a speech delivered by Krueger at the time, encouraging the orderly and timely restructuring of unsustainable sovereign debts would have several bene-

¹www.imf.org/external/np/sec/pn/202/pn0238.htm (April 1, 2002).

fits: help private investors distinguish between good and bad risks, help countries with good policies attract capital more cheaply, and help prevent countries with weak policies from building up excessive debts that might leave them vulnerable to a major crisis.² All in all, she said, facilitating sovereign debt restructurings “would result in a better allocation of global capital and make the international financial system stronger, more efficient and more stable.”

Treasury Under Secretary Taylor, for his part, argued in a presentation given contemporaneously that: “A more predictable sovereign debt restructuring process for countries that reach unsustainable debt positions would help reduce . . . uncertainty. It would lead to better, more timely decisions, reducing the likelihood of crises occurring and mitigating crises that do occur.”³ But Taylor was much more forthcoming about why the G7 governments are so keen on lubricating the world’s financial system by improving sovereign bankruptcy procedures: “Limiting official sector support when countries reach unsustainable debt situations is also a key element of our emerging markets strategy. . . . The uncertainty that currently exists leads to pressures for large [official] support packages. Reducing this uncertainty will reduce such pressures.” In other words, by facilitating sovereign defaults on bonded debt and negotiations on the postponement of interest payments and the forgiveness of principal obligations, the G7 and the IMF will no longer need to put together large packages of official support for presumably insolvent governments.

Krueger’s earliest proposal (November 2001) called for the amendment of relevant legislation in all countries to permit qualified majorities of bondholders to restructure all new sovereign bond issues under the aegis of the IMF. It contemplated that debtor governments could appeal to the Fund for a temporary stay on debt-service payments and that the IMF would play the role of a benign bankruptcy judge, managing the process whereby a restructuring proposal is negotiated that would be binding on all bondholders. Since none of the abrogation of bondholder rights is envisioned under any current national laws, particularly in the jurisdictions of choice to issuers and investors (New York State and the UK), the proposal would have required uniform amendments to all domestic legislation. Whatever the inherent justification and merits of this proposal, it was—to say the least—exceedingly impractical.

Krueger’s latest proposal (April 2002) calls for another statutory solution, this time achieved through a universal treaty obligation rather than via piecemeal amendments to national laws. Said obligation could most easily be established by amending the IMF’s founding charter upon a favorable vote by those member nations accounting for eighty-five percent of total voting power—far fewer than eighty-five percent of individual country members. The vote would empower the Fund to play a role not presently contemplated by national laws governing bond issues. Ms. Krueger’s additional innovation is that now the Fund would no longer be empowered to make decisions limiting creditor rights. The sovereign debtor and a qualified majority of its bondholders would make the essential restructuring decisions instead. However, the Fund would surely play at least the role of an expert witness, rendering an opinion on how much debt forgiveness from bondholders a country in trouble requires. This second proposal, requiring as it does approval by several parliaments beyond those in the G7 countries (which account for 45.5 percent of the IMF’s voting power), is at least less impractical than the first one.

Taylor’s proposal (April 2002) eschews statutory solutions in favor of a contractual, market-oriented approach. He proposes building a consensus among emerging-market issuers, final investors and financial intermediaries that future bonds should have new collective-action clauses in their contracts describing as precisely as possible what would occur when a sovereign obligor decides it must obtain relief.⁴ The first of these is a majority-action clause, permitting a sizeable majority of bondholders (say, seventy-five percent of total) to agree to a restructuring of terms and conditions—a restructuring that would be binding on the minority. The second would spell out the process by which debtors and creditors come together when a restructuring occurs—in particular, who would represent bondholders. The third would be a clause describing how governments are to initiate the restructuring process, namely, how they may declare a cooling-off period during which payments may be deferred without threat of litigation. To encourage the incorporation of these new clauses into new bond offerings, and possibly spur swaps of old debt without the clauses for new issues with them, Mr. Taylor proposed two ideas. “First, the official sector could require that these clauses be used by any country that has, or is seeking, an IMF program. Second,

²www.imf.org/external/np/speeches/2002/040102.htm (April 1, 2001).

³www.ustreas.gov/press/releases/po2056.htm (April 2, 2002).

⁴Collective action clauses already exist in bonds issued under United Kingdom law, but most (around 70%) of the outstanding bonds of emerging-market sovereigns have been issued in other jurisdictions (such as New York and Frankfurt) where such clauses are not customary.

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the official sector could provide some financial enhancement, such as slightly lower charges on IMF borrowing for countries that include these clauses in their debt.” The Executive Board of the IMF discussed these latter ideas last June, but they did not gain the support of most government representatives.⁵

This past September, the G7 nations endorsed a dual-track approach to facilitating the sovereign debt-restructuring process, backing both the Krueger and Taylor initiatives, even though the former would clearly supercede the latter. Outside G7 circles, however, attitudes toward the sovereign bankruptcy initiatives are very different. The Krueger approach has generally failed to find any private-sector support, and it has little official support outside the G7 nations. For example, finance ministers representing the Group of 24 leading developing countries have recently stated that while remaining “open-minded” about the incorporation of collective action clauses into bond contracts, they are “skeptical” of proposals entailing an amendment to the IMF’s charter.⁶ Indeed, the Taylor proposal is widely viewed as the lesser of two evils among sovereign issuers, financial intermediaries, and informed investors.

The Institute of International Finance (IIF), a Washington-based research and advocacy group that represents the world’s largest private financial institutions (including the author’s employer), was the first to announce that it favors an approach that involves the inclusion of collective-action clauses into new bond contracts. However, the approach would also feature a private-sector advisory group to work with troubled debtors and the official community as well as a partnership between private financial institutions and governments to limit disruptive creditor litigation.⁷ The pursuit of such market-based approaches was later endorsed by five other private-sector organizations: the Emerging Markets Creditors Association, EMTA (an association of traders of emerging markets’ debt instruments), the International Primary Markets Association, the

Securities Industry Association, and The Bond Market Association.⁸ The U.S. Treasury and leading investment bankers have been searching for at least one reputable emerging-market sovereign willing to volunteer to issue a benchmark bond with new collective-action clauses facilitating an eventual restructuring, but so far they have not been successful. A test transaction would obviously be a coup for the U.S. Treasury, considering that the G7 governments have yet to find a volunteer for their four-year-old initiative to prevent financial crises by granting a contingent credit line to countries that want a “good housekeeping seal” from the IMF.

Assessment

Many investors, financial intermediaries, and emerging-market government officials are at a loss to understand why the G7 and the IMF believe they would be better off if the supposedly bumpy road to sovereign bankruptcy were to be paved over. Indeed, the proposition that the world would be a safer place if mechanisms were to be agreed upon and implemented that would enable governments to default has little intuitive appeal. Practical experience suggests that, despite the strong rights that bondholders have on paper under New York and UK law, the enforcement of claims against sovereign governments is exceedingly difficult. Whereas delinquent corporations can be hauled, *de jure* and *de facto*, before a bankruptcy court and be forced to change management, restructure operations, dispose of assets, or even liquidate to pay off claims, governments cannot be subjected to the same treatment. The main disincentives against sovereigns defaulting are the loss of reputation and of credit ratings, the temporary isolation from the international capital markets, and the fallout from default in terms of domestic confidence, local interest rates, and the exchange rate. Those in the business of issuing, underwriting or investing in sovereign bonds are generally of the view that, if anything, international reforms should focus on making contracts easier to enforce and on facilitating the constructive involvement of bondholders in debt-restructuring negotiations. Only Mr. Taylor’s frank admission that what the G7 really wants is to minimize the need to bail out countries with multibillion-dollar packages, to be accomplished by facilitating default as an option for cash-strapped governments, makes some sense—from a purely selfish G7 perspective, that is.

To begin with, the governments of Ecuador, Pakistan, Russia, and the Ukraine have all been able to restructure their bonded debt in recent years, without recourse to or

⁵www.imf.org/external/np/sec/pn/2002/pn0277.htm (July 26, 2002).

⁶www.imf.org/external/pubs/ft/survey/2002/100702.pdf (October 7, 2002), p. 312.

⁷www.lif.com/data/public/icdc0402.pdf (April 9, 2002).

⁸www.emta.org/ndevelop/oneill.pdf (June 3, 2002).

even in the absence of collective-action clauses—never mind favorable legislation at the national or international level. Substantial debt-service relief and even sizeable debt forgiveness were obtained through the use of exchange offers, sometimes accompanied by so-called exit consents that encouraged the participation of as many investors as possible in take-it-or-leave-it settlements. In the case of Romania, the original cash flow and private-sector involvement objectives were attained via the placement of a new bond issue rather than a potentially traumatic restructuring of past obligations. Experience has demonstrated that neither the threat of litigation nor actual cases of litigation have obstructed these various emergency financial operations. Although it is true that one lone creditor was able to use the New York and Brussels courts to collect payment from a formerly bankrupt government (*Elliott Associates vs. Peru* in 2000), the amount involved was relatively small, the favorable judgments took years to be obtained, the government would have been likely to prevail upon appeal, and most importantly the country's debt restructuring under the Brady plan was neither obstructed nor invalidated.

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Beyond this experience from the recent past, it would behoove the G7 governments to ponder whether the recent tragedy in Argentina would have been avoided if either the Krueger or Taylor approaches to sovereign bankruptcy had been in place in 2001. It is possible that the G7 governments would have slammed the door on Argentina earlier than in the final two months of that year: they might have refused to put together a medium-size package of financial support in late 2000 or might have refused to augment it modestly in August 2001 if an elegant sovereign bankruptcy mechanism had been available. Yet, the absence of a smooth debt-restructuring process did not stop G7 officials from slamming the door on Russia in mid-1998, despite potentially catastrophic worldwide economic consequences. It did not stop the G7 from forc-

ing unwilling Ecuador (in 1999) into the first-ever default on Brady bonds and the first-ever default on sovereign Eurobonds issued in the second half of the twentieth century. It did not stop the G7 governments from insisting that Indonesia, Pakistan, and the Ukraine restructure their obligations to bondholders or commercial banks (falling due in 1999-2002) to obtain IMF financial support or debt relief from official creditors via the so-called Paris Club.

Similarly, it is possible that the Argentine authorities would have decided to declare a moratorium on debt payments much earlier than in December 2001 if they had had greater certainty about the bankruptcy process. Yet, the final outcome—an economic depression—would have been exactly the same. Since a substantial proportion of the Argentine government's debt obligations were held by local banks, pension funds, and insurance companies, any announcement of a payments stand-still with the intention to seek massive debt forgiveness would have triggered a stampede of bank depositors and a collapse of the pension and insurance industries. This would have led to a run on the central bank's official reserves, precipitating a devastating currency devaluation and thus the same economic implosion, political fallout and popular discontent that we witnessed in 2002. The only difference is that it would all have unfolded several months earlier, with no benefit accruing to anyone—except the G7 and the IMF, which would surely not have made the eleventh-hour disbursement they made in September 2001. But then, they might have been more generous with Argentina earlier on.

The Underlying Problem

The controversy about sovereign bankruptcy procedures makes sense only as a G7 strategy to enable it and the IMF to scale back support for governments in financial trouble. As the discussion that follows will show, it is not necessary to have improved bankruptcy mechanisms in place to reverse a policy approach that has outlived its usefulness. What is needed is for the G7 nations to extricate themselves from the big bailout business.

The multibillion-dollar G7 and IMF rescue packages trace their conception to the final days of 1994. It was then that the newly inaugurated Ernesto Zedillo administration in Mexico found itself with insufficient reserves of U.S. dollars to meet debt obligations maturing in the first months of 1995. To avoid having to default and suffer the economic and political consequences, President Zedillo appealed to the White House for extraordinary financial support. The Clinton administration obliged, digging deeply into its own pockets and persuading other G7 governments and the IMF to do the same. Interestingly, the existence of a sovereign bankruptcy framework of the

Krueger or Taylor varieties would have made no difference to Mexico seven years ago. The debt obligations at stake were not bonds issued under New York or UK law. Instead, the equivalent of more than \$25 billion in dollar-indexed Mexican Treasury securities was subject only to Mexican jurisdiction—the so-called *Tesobonos*. Nothing of an international legal nature stopped the Zedillo administration from negotiating a restructuring with its bondholders, submitting a law authorizing a postponement of payments to the then rubber-stamp Congress, or appealing for relief to the pliant Mexican courts.

The success of the Mexican bailout of 1995, in the sense that Mexico was on the mend and able to pay back the U.S. Treasury and other official creditors within a couple of years, encouraged the U.S. government to spearhead a series of other bailouts in Asia and Russia during the financial crises of 1997 and early 1998. The Robert Rubin-Larry Summers Treasury team essentially adopted the Colin Powell military doctrine of the early 1990s: intervene, if you must, but with overwhelming force. They stitched together several bailouts, measured in the tens of billions of dollars, that were intended to forestall damaging defaults by convincing domestic and foreign creditors that Thailand, Indonesia, South Korea, and Russia had the necessary financial wherewithal. Here, too, the absence of a sovereign bankruptcy framework of the Krueger or Taylor varieties made no visible difference. When the G7 governments realized in December 1997 that the aid they were pouring into South Korea was leaking out in the form of debt repayments to foreign commercial banks, they did not hesitate to pressure the newly inaugurated Kim Dae Jung administration to restructure obligations to the banks. Likewise in Russia several months later: the burning issue was whether to default on domestic Treasury instruments (the so-called GKO and OFZs) that were unprotected, like Mexico's *Tesobonos*, by international law. In the wake of a G7 cut-off of financial assistance to Moscow, of course, the Boris Yeltsin administration ended up defaulting on them, much like President Zedillo would have done two-and-a-half years earlier, but for G7 support.

The magnitude of the G7's departure from previous practice since 1994 is illustrated by the extent to which the IMF's guidelines for financial assistance have been stretched in recent years. The Fund's original charter, drawn up in 1944, authorized member countries to borrow as much as one hundred percent of their quota, namely, no more than the amount of their initial subscription into the IMF, which varied according to a country's size and other factors. This ceiling was subject to exceptions "especially in the case of members with a record of avoiding large or

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continuous use of the Fund's resources." However, as trade flows expanded rapidly during the 1950s and 1960s and quotas were not raised, the exceptions became increasingly common; and programs were often in the range of 100-200 percent of quota.

During the difficult 1970s and early 1980s, cumulative access limits were repeatedly raised to a peak of 600 percent of quota—in response to two world oil crises, two global recessions, and the onset of Latin America's debt crisis. When the international financial emergencies subsided and the size of member contributions was increased during the 1980s and 1990s to reflect the expansion of world trade, however, cumulative access ceilings were reduced to a maximum of 300 percent of quota. This is the limit that has prevailed since 1992, although again with exceptions allowed for extraordinary circumstances. Yet, the consensus view developed in the 1980s and early 1990s was that disbursements by the IMF could not possibly suffice to plug most of the holes of a leaking sovereignty of state. The Fund was to play a catalyst role, providing seed money for a turnaround and encouraging the financial markets to regain confidence and provide the bulk of whatever funding was necessary.

It is against this background that the aid provided by the IMF in recent years must be measured. Table 1 shows the extraordinary levels of funding provided by IMF since 1995. Moreover, additional sums were provided by the treasuries of the G7 governments bilaterally, via the Bank for International Settlements, and by the World Bank and the respective regional development banks, until all of the aid packages could be measured in the tens of billions of dollars.

It is likely that what we call the Powell doctrine as applied to international finance has created as many problems as it has solved. The possibility that a country may or may not get a huge package of financial support with which to meet its debt obligations has become one of the key elements in the assessment of sovereign creditworthiness. Many credit ratings, analyst recommendations, and investment decisions hang on the understanding that this

TABLE 1

TOTAL ACCESS TO IMF FUNDS UNDER SOME RECENT PROGRAMS (% OF QUOTA)¹

	Total access granted
Mexico 1995	688
Thailand 1997	505
Indonesia 1997	490
Korea 1997	1,938
Russia 1998	449
Brazil 1998	600
Argentina Jan 2001	500
Turkey 2001	1,560
Argentina Sep 2001	800
Turkey 2002 ²	2,548
Uruguay 2002 ³	743
Brazil 2002 ⁴	1,127

¹The cumulative access limit prevailing during this time period was 300 percent of quota.

²Result of new credit facility replacing a previous one, and considering new amount made available (SDR 12.8 billion) plus disbursements already made under prior arrangement (SDR 11.7 billion).

³Result of new credit facility replacing a previous one, and considering new amount made available (SDR 2.13 billion) plus disbursements already made under prior arrangement (SDR 150 million).

⁴Result of new credit facility replacing a previous one, and considering new amount made available (SDR 22.8 billion) plus disbursements already made under prior arrangement (SDR 11.4 billion).

Source: IMF, ABN AMRO

or that foreign government is viewed with favor by the White House, Downing Street, and beyond. This suggests that some countries will be rescued on strategic grounds, despite the cause of their woes, the merits of their reaction plan, or the availability of legal recourse. This is akin to having to pick stocks or bonds for a portfolio not on the basis of whether a weak company will manage to turn itself around but, rather, on whether it will be nursed back to health via a possible infusion of large-scale government support. How could the U.S. financial markets possibly function well if *deus ex machina* rescues à la Chrysler were to be commonplace? Yet this interference is what issuers, investors, and intermediaries operating in the emerging markets have had to contend with during the past seven years.

The time has come to scale back the official financial support made available to errant nations, and a decision along these lines need not await improved sovereign bankruptcy procedures. As a necessary first step, the G7 should get the IMF out of the business of providing huge packages of aid measured in many multiples of a country's quota. Although re-establishing as low a relative ceiling for aid as prescribed by the IMF's founders would emasculate the Fund needlessly, the objective should be for access levels to be consistent only with the provision of seed money for

economic and policy turnarounds on as objective a basis as possible. It is patently unfair that some governments should be lavished official aid, and others should be starved, when the IMF is a co-operative to which its member governments should be able to turn for fairly automatic, albeit limited, help. Scaled-back official intervention on behalf of countries in trouble will likely encourage governments and their bondholders to consider much more seriously the implications of falling into the abyss of bankruptcy—regardless of whether or not either of the current G7 initiatives ever yield some fruit.

Outlook

In sum, the U.S. Treasury has joined its G7 counterparts in giving top priority to finding ways of facilitating a bankruptcy process for heavily indebted nations, including via an expanded role for the IMF. It has done this even though recent experience does not justify it: the absence of said procedures has not impeded several landmark debt workouts; in instances when the bankruptcy option was available it has been avoided; and the existence of an orderly process would not have prevented, for instance, the debacle in Argentina. In our view, the Treasury's and IMF's persistent advocacy on this issue has started to alienate the already limited investor base for sovereign bonds that are rated below investment grade, except in the case of those countries deemed to be "protected" because they are of strategic interest to the G7 (such as Colombia and Turkey). Pushing a sovereign bankruptcy process may also encourage reform fatigue and reduced fiscal discipline in some of the weakest sovereign credits—including Argentina—because of the allure of an eventual "fast track" to debt forgiveness. Besides, if the real purpose behind the initiatives is to extricate the G7 countries from the big bailout business, the best way to accomplish this is by reintroducing limits to the rescue packages that the IMF is allowed to put together.

The less harmful of the options being pursued involves the voluntary adoption of collective action clauses in bond covenants, which would facilitate a renegotiation of terms and conditions should circumstances warrant it. At present, most emerging-market issuers and investors are loath to introduce such clauses for fear of signaling that they contemplate or countenance an eventual default—something akin to the chilling effect that talk of a prenuptial agreement tends to have on a marriage. In any case, even if such clauses were to be introduced voluntarily in new issues, the stock of outstanding bonds would still be governed by preexisting legal covenants, such that their practical effect would be absolutely marginal for many years to come.

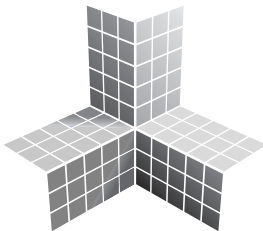
The more harmful option entails amending the IMF's charter allowing it to override national legislation, thus establishing a supranational bankruptcy procedure. This attempt to amend the IMF's charter will take several years to take effect, if at all, because it must be approved by the national parliaments of many countries. ■

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