

Bankruptcy Lite

Has the Powell Doctrine as applied to international finance created more problems than it has solved?

BY ARTURO C. PORZECANSKI

In a thinly veiled effort to scale back country bailout programs, the IMF and the U.S. Treasury are floating proposals they hope will encourage governments and bondholders to undergo a debt-workout process. The idea, of course, is that if the road to default were paved rather than bumpy, troubled countries would increasingly choose to get their books in order rather than eke by on massive international bailouts. Anne Krueger, first deputy managing director of the IMF, and John Taylor, under-secretary for international affairs at Treasury, have made this project their first and top priority — all the more so following Argentina's woes. Proposals they put forward were formally endorsed at the April meeting of G7 finance ministers and central bank governors in Washington.

But the absence of bankruptcy procedures has not impeded several landmark debt workouts. And in several cases where bankruptcy options were available to insolvent countries, they were avoided. What's more, even if the IMF and Treasury initiatives had been in place last year, the collapse in Argentina would not have been prevented. In fact, the only sure-fire way for the G7 and the IMF to give away less money is by — surprise! — giving away less money.

But commonsense hasn't been commonplace in this debate. Krueger's first proposal last November, for example, called for an amendment to relevant legislation in *every* country to permit qualified majorities of bondholders to restructure all new sovereign bond issues

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under the IMF's aegis. Whatever its merits, the need for universal acceptance made this a hopelessly impractical proposal. Her second initiative, in April, called for an amendment to the IMF's founding charter



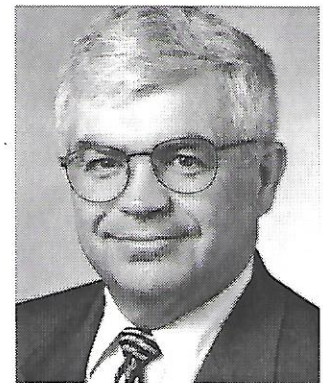
The IMF's Anne Krueger.

to empower it to play more of a mediating role. This was slightly more realistic — it would require passage by countries accounting for 85 percent of IMF votes, and the G7 alone commands more than half of that. But it still expands the IMF's ability to meddle.

Taylor's proposal, on the other hand, was less quixotic, eschewing statutory solutions in favor of a contractual, market-oriented approach. In April he called on emerging-market issuers, final investors and financial intermediaries to agree that future bonds should have new collective-action clauses in their contracts spelling out how a sovereign obligor would go about obtaining debt relief, and making it easier for a sizeable major-

payment on the part of shaky governments, and that it does nothing to facilitate the enforcement of bond contracts or the collection of claims on debtors.

Most investors, financial intermediaries and emerging-market government officials are at a loss to understand why the G7 wants the road to sovereign bankruptcy cleared of hurdles. In fact, the absence of a bankruptcy procedure has not impeded several landmark debt workouts. 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 even in the absence of collective-action clauses. 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. Neither the threat of litigation nor actual cases of litigation obstructed these workouts. Although one lonely creditor was able to use the New York and Brussels courts to collect payment from a formerly bankrupt government (*Elliot Associates vs. Peru* in 2000), the amount involved was relatively small, the judgment took several years to reach, and Peru's debt-relief plan was not invalidated.



The U.S. Treasury's John Taylor.

Of course, the impetus for all of this G7/IMF brainstorming has been Argentina. But the country's bankruptcy would not have been avoided if either the Krueger or Taylor plans had been in place last year. While it's possible that the G7 governments would have slammed the door on Argentina earlier than in late 2001 if an "elegant" sovereign bankruptcy mechanism had been inaugurated, the absence of a smooth debt-restructuring process never stopped G7 officials from slamming the door on Russia in mid-1998, despite catastrophic worldwide economic consequences. Nor did it stop them in 1999 from forcing unwilling Ecuador into the first-ever defaults on Brady bonds and sovereign Eurobonds. And it didn't stop them over

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ity of bondholders to agree. The Taylor proposal has encountered less rejection and even some conditional acceptance among the private sector. However, most bondholders rightly worry that it will encourage non-

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the last three years from insisting that Indonesia, Pakistan and the Ukraine restructure their obligations to bondholders or commercial banks to obtain IMF financial support or debt relief from official creditors.

Similarly, it is possible that the Argentine authorities would have decided to declare a moratorium on debt payments much earlier in 2001 in the presence of an “easy” bankruptcy option. But the final outcome would have been exactly the same. Because a substantial proportion of Argentine government debt

obligations was held by local banks and pension funds, 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 industry. This, in turn, would have led to a run on the central bank’s official reserves, precipitating a devastating currency devaluation — and the same economic disruption, political fallout and social turmoil witnessed in recent months. The only difference is that it all would have unfolded several months earlier.

Experience likewise suggests that in several cases where the sovereign bankruptcy option was available, it was nonetheless avoided. The business of assembling multibillion-dollar G7 rescue packages goes back to Mexico in the final days of 1994. It was then that the newly inaugurated Ernesto Zedillo administration found itself with insufficient international reserves to meet debt obligations and appealed to the White House for ex-

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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	2,544

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

Result of new credit facility replacing a previous one, and considering new amount made available (SDR12.8bn) plus disbursements already made under prior arrangement (SDR11.7bn).

Source: IMF, ABN AMRO

traordinary financial support. Yet the debt obligations at stake were not bonds issued under foreign law, but dollar-indexed Mexican Treasury securities subject only to Mexican jurisdiction — the infamous Tesobonos. Nothing of an international legal nature stopped the Zedillo administration from negotiating a restructuring with its bondholders.

The success of the Mexican bailout of 1995 — in the sense that Mexico was on the mend and able to begin 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 1997-98. The Bob Rubin-Larry Summers Treasury team essentially adopted the Colin Powell military doctrine of the early 1990s: Intervene if you must, but do so with overwhelming force. The result was several bailouts, each measuring in the tens of billions of dollars, which were intended to forestall damaging defaults by convincing domestic and foreign creditors that Thailand, Indonesia, South Korea and Russia had the necessary financial wherewithal.

But there, too, the absence of a sovereign bankruptcy

framework made no visible difference. When the G7 governments realized in late 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 government to restructure obligations to banks. Likewise in Russia several months later: The burning issue was whether to default on domestic Treasury instruments 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 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 authorized member countries to borrow as much as 100 percent of their quota — that is, no more than the amount of their initial subscription into the IMF. This ceiling was subject to exceptions "especially in the case of members with a record of avoiding large or continuous use of the Fund's resources." As trade flows expanded rapidly during the 1950s and 1960s and quotas were not raised, however, the exceptions became increasingly common, and programs were often worth up to 200 percent of quota.

During the difficult 1970s and early 1980s, in response to two world oil crises, two global recessions and the onset of Latin America's debt crisis, cumulative access limits were repeatedly raised to a peak of 600 percent of quota. Yet the IMF always played 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. 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, cumulative access ceilings were reduced to a maximum of 300 percent of quota — the limit that has prevailed since 1992.

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It is against this background that the aid provided by the IMF in recent years must be measured. Mexico, in 1995, was awarded a program worth nearly 700 percent of its membership quota; Thailand and Indonesia (1997) about 500 percent

of their respective quotas; South Korea (1997) a whopping 1,940 percent of quota; and Russia (1998) 450 percent of quota. Moreover, large additional sums were provided by the treasuries of the G7 governments bilaterally or 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. Brazil's 1998 IMF

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program was worth 600 percent of quota; Argentina's grew to 800 percent of quota. And Turkey is being showered with an eye-popping 2,550 percent of quota — that's \$31bn for a country whose membership contribution is \$1.2bn.

There is growing consensus that 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 assessing sovereign creditworthiness. Many credit ratings, analyst recommendations and investment decisions hang on whether this or that foreign government is viewed favorably by the White House — that it will be rescued on strategic grounds and despite the cause of its woes, the merits of its reaction plan or the availability of legal recourse. This is akin to picking stocks or bonds for a portfolio not on the basis of whether a weak company will manage to turn itself around, but on whether it will be nursed back to health by a huge infusion of government cash. How could the U.S. financial markets possibly function well if *deus ex machina* rescues such as Chrysler's were commonplace?

The time has come for some financial tough love. Official financial support to errant nations must be scaled back, and a decision along these lines need not wait for improved sovereign bankruptcy procedures. The Fund should go back to providing a limited amount of seed money for economic and policy turnarounds on as objective a basis as possible. After all, if bailout money is scarce, governments and their bondholders will be encouraged to consider much more seriously the implications of bankruptcy. Since necessity is the mother of invention, chances are that more progress will be made in terms of developing sovereign debt-restructuring procedures by the parties directly interested in the outcome than is likely to materialize from the current IMF and U.S. Treasury initiatives. ♦