

## REVIEW

# Debt Relief by Private and Official Creditors: The Record Speaks

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Eduardo Borensztein, Eduardo Levy Yeyati and Ugo Panizza (eds), *Living with Debt: How to Limit the Risks of Sovereign Finance*. Washington, DC: Inter-American Development Bank, 2006.

Chris Jochnick and Fraser Preston (eds), *Sovereign Debt at the Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis*. New York: Oxford University Press, 2006.

Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*. Cambridge, MA: The MIT Press, 2006.

### I. Background

The 2006 crop of scholarly books on sovereign debt issues is an interesting one, as the editors and authors involved take very diverse perspectives. The three volumes reviewed here (in Section VI, 'Lessons from Recent Debt

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Crises'), which attempt to draw conclusions from recent sovereign debt troubles, are best appreciated after putting them in historical context. I begin, therefore, by providing my own assessment of what the international financial community has – and has not – achieved in terms of dealing with sovereign indebtedness problems in the past 20 years or so.

During the 1990s and in the earlier part of this decade, certain academic scribblers on both sides of the Atlantic, plus policy makers in Washington, London, and beyond, flogged the idea that the functioning of the world's financial markets had to be improved. To do so required making it easier for governments in unstable emerging markets to obtain debt relief from their private creditors in times of financial distress. Various proposals envisaged creating a new legal regime for sovereign bankruptcy, achieved through an international treaty buttressed by amendments to existing national bankruptcy codes. It would empower a supranational entity to render Solomonic judgements about the illiquidity or insolvency of sovereigns, overriding all outstanding loan and bond contracts (Rogoff and Zettelmeyer 2002).

The best known of these was the Orwellian construct of a supranational 'Sovereign Debt Restructuring Mechanism' (SDRM) to operate under the aegis of the International Monetary Fund (IMF). The SDRM was conceived in 2001 and was subsequently modified during 2002–03 by a self-serving IMF (Krueger 2002; Hagan 2005). In the face of universal criticism from private-sector lenders and investors, and also from leading emerging-market governments such as Mexico's, the proposal ultimately failed to attract the requisite political support from the United States and others. Besides, at the time the world economy was looking up and no new sovereign disasters – at least not with systemic implications – appeared to be in the making. Argentina, which had defaulted at the end of 2001 despite having received good marks and huge loans from the IMF, was eschewing the traditional, collaborative approach and was crafting its own unilateral restructuring of debt obligations. In addition, the threat of an SDRM coming to pass was persuading investors and sovereign issuers alike to introduce new collective-action clauses into bond contracts, with the goal of facilitating future debt restructurings.

The ostensible rationale for all the brainstorming on the part of policy makers and their academic consultants was to ameliorate the supposedly undesirable consequences of having had to come to the rescue, during the 1990s, of a number of troubled sovereign debtors (e.g. Mexico in 1995 and various Asian countries, along with Russia and Brazil, in 1997–98). Stung by criticism of having encouraged reckless investors and over-indebted countries to come knocking at their door pleading for truckloads of money, the United States and other governments reportedly wanted to open up an alternative – a fast track to default, debt forgiveness and financial resurrection. Thus, when in the future a government under financial duress came

looking for massive financial help, it would no longer be able to claim that the only alternative to a bailout was a hopelessly disruptive, delayed and uncertain default with potential spillover effects around the globe. With some kind of sovereign bankruptcy process in place, Washington and its G7 partners would feel free to tell that government that it should seek debt relief from its private creditors, availing itself of the supposedly quick, orderly and painless debt-restructuring mechanism.

A more cynical interpretation of all this intellectual and policy-making brouhaha is that the United States and its Canadian, European and Japanese partners purposely kicked up the SDRM storm to divert public attention from their own reluctance to accept loan losses and to grant debt forgiveness, whether to over-indebted middle-income nations or to the poorest countries in the world. To this day, the official export-credit and foreign-aid agencies represented by the Paris Club, as well as the multilateral agencies (such as the World Bank and the regional development banks – never mind the IMF), have yet to grant any debt cancellation to the middle-income countries that were the object of (fully repaid) bailouts during the 1990s and the recipients of subsequent debt forgiveness from the private sector.<sup>1</sup> Regarding debt reduction in low-income countries [via the Heavily Indebted Poor Countries (HIPC) Initiative of 1996, as enhanced in 1999 and later supplemented by the Multilateral Debt Relief Initiative, or MDRI, in 2005], it took a full decade for 21 countries to reach the so-called completion point, at which time they finally received the debt forgiveness committed to them previously. Consequently, dozens of exceedingly poor countries remain burdened with unsustainable debts that tie up the budgetary resources needed to fund poverty reduction and other initiatives.

Indeed, given Argentina's punishing, unilateral debt restructuring, which three-quarters of its bondholders were compelled to swallow in 2005, a case can be made that, if anything, international reforms should focus on making contracts easier to enforce. They can do this by paring back the protections sovereign debtors are currently afforded, for example under the US Foreign Sovereign Immunities Act (Scott 2006). The main reason corporations that cannot pay their creditors subject themselves to wrenching, court-supervised reorganizations is because the alternative is the much more frightening outright liquidation. Sovereign governments, in contrast, do not operate under the threat of liquidation, and despite the strong rights that private creditors have on paper (under New York, English and other law), practical

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<sup>1</sup>As mentioned below, in a handful of unique cases of political importance to the United States (involving Egypt, Iraq, Poland and the former Yugoslavia), and in the recent case of Nigeria, the Paris Club did grant various levels of debt forgiveness, but none of the countries involved had been the object of a massive bailout.

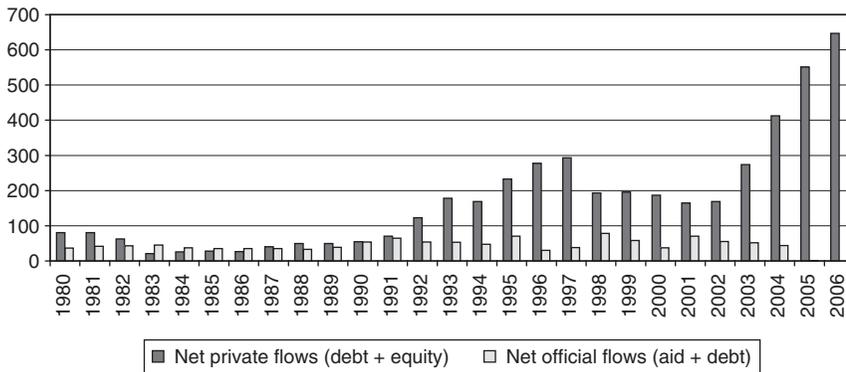
experience – reinforced by the ongoing case of Argentina – proves that the enforcement of claims against sovereign governments is exceedingly difficult. Whereas delinquent corporations can be hauled, *de jure* and *de facto*, before a bankruptcy court and be forced to change management, restructure operations, dispose of assets, or even liquidate to pay off claims, governments are not subjected to any of those conditions. Much as the storybook child who blurted out the truth about his Emperor being naked, a rogue sovereign debtor like Argentina has single-handedly managed to undermine the integrity of the international financial system, exposing its inherent fragility for all to see (Porzecanski 2005).

## **II. From the Mid-1950s to the Late 1980s**

The road from debt restructuring to debt forgiveness – from reprofiling to cancellation, in the jargon of the official community – has been a fairly short one for private creditors but a very long one for the two kinds of government lenders: bilateral creditors, mainly export-credit and foreign-aid agencies (such as the US Ex-Im Bank and AID, and their equivalents in other countries), and multilateral creditors, such as the World Bank, the regional development banks (e.g. the African, Asian, European and Inter-American development banks) and the IMF.

In 1955, six European countries decided to pursue a joint approach to clearing the financial obligations Brazil had built up with them; they did so by meeting in The Hague. Within a year's time, a similar gathering involving even more European countries took place in Paris, this time to deal with \$500 million of Argentine debts coming due after the overthrow of the Juan Domingo Perón regime. While more than a decade would have to pass before France established an effective monopoly over the process of restructuring debt owed to government agencies (including newcomers Canada, Japan and the United States, during the 1960s), what is now known as the Paris Club evolved as a pragmatic rather than a planned solution to the problem of overly burdensome sovereign debts (Rieffel 2003, pp. 56–94).

In the second half of the 20th century, the balance of payments deficits of the developing countries went from being financed mainly by government agencies in the industrialized countries to being underwritten largely by private-sector lenders and investors, mostly from those same industrialized countries. From the creation of the Paris Club until the mid-1970s, the main external financing flows were provided by official foreign aid and trade-credit agencies, or else by multilateral lenders such as the World Bank and the IMF. In this first phase, when developing countries encountered external financial problems, they would go to the IMF for assistance in the prepara-

**Chart 1:** External financing to all developing countries (\$ billions)

Source: World Bank, *Global Development Finance, various issues*.

tion and implementation of a stabilization programme, which was underwritten by a short-term loan from the Fund, and then they would sit down with their bilateral creditors in Paris to work out debt relief along what are called ‘Classic’ terms. Credits previously granted by foreign aid and export credit agencies were rescheduled at market interest rates with a principal repayment profile negotiated on a case-by-case basis. The loans made by multilateral agencies were not similarly restructured – they were granted de facto top seniority in the chain of cross-border payments. Private creditors (mainly banks and suppliers) were often unaffected because of their limited exposure to these developing countries.

Since the mid-1970s, however, private-sector lenders and investors – commercial banks at first, then bondholders and equity investors – have underwritten all but the poorest and most mismanaged developing countries (see Chart 1). When commercial banks were the largest providers of external finance (from the mid-1970s until the early 1990s) and a country found itself in financial difficulties, it would turn to the IMF for guidance and financial support – but then it would sit down with its commercial bank creditors to work out a mutually acceptable debt rescheduling. These meetings would largely take place either in New York (involving Latin American countries) or in London (involving Eastern European, Middle Eastern and African countries) – giving rise to the term ‘London Club’ for another ad hoc process of debt negotiations that would be refined through time (Rieffel 2003, pp. 95–131). The Paris Club would then chime in with a debt restructuring along Classic terms, and the multilateral agencies would pledge substantial new lending in lieu of any reprofiling of their existing loans.

### III. From the Late 1980s to the Present

In the late 1980s, however, after a number of countries (particularly in Latin America) had gone through multiple debt restructuring exercises that still left them over-indebted, the US government came up with what became known as the Brady Plan, named after the then US Secretary of the Treasury. The commercial banks (London Club) were pressured into granting sizeable, permanent debt forgiveness, and to do so by exchanging existing loans for long-term bonds issued by the developing countries, which incorporated either a reduction in the principal owed or below-market interest rates. The principal of these 'Brady' bonds was often guaranteed and a rolling portion of the coupon payments was collateralized. To come up with the requisite collateral, the debtor governments would purchase high-quality securities (including special zero-coupon bonds issued by the US Treasury), supplementing their own resources when needed with loans from the IMF and the World Bank. In addition, the countries would commit to economic reforms underwritten in part by the multilateral agencies. Nevertheless, all of the debt forgiveness was granted upfront by the private creditors, and was neither conditioned on need as determined by the banks – the extent of debt relief was essentially dictated by the IMF – nor on ongoing, good performance on the part of the sovereign debtors.

The Paris Club, in sharp contrast, did not grant any debt reduction to the countries that had obtained it from their commercial bank lenders under the Brady Plan, instead adhering to its usual debt reprofiling exercises. The only concession made, starting in late 1990, was to reschedule the obligations of lower-middle-income countries under so-called Houston terms, featuring longer repayment periods and lower interest rates on foreign aid loans. Among the Brady Plan beneficiary countries that obtained said Houston terms during the early 1990s were Ecuador, Morocco, Nigeria, the Philippines and Peru. All of the largest debtors, such as Argentina, Brazil and Mexico, however, had their Paris Club debt restructured under ordinary, Classic terms. The multilateral lending agencies, for their part, did not engage in any debt restructuring, even in the face of some protracted defaults (e.g. on the part of Peru). Instead, they preferred to underwrite the developing countries, as noted, by making new loans in support of creditworthiness-enhancing reforms and the purchase of high-grade securities to back the Brady bonds.

In April and May 1991, this time it was the Paris Club, also under pressure from the US government, that was persuaded to make an exception and grant permanent debt forgiveness to two countries, the first of which would end up issuing Brady bonds: Poland (considered middle income) and Egypt (lower middle income). Both obtained a halving of their financial obligations to the Paris Club measured on a net-present-value (NPV) basis, namely,

combining debt write-offs with interest payments set below the creditors' cost of funds. The official rationale for this unprecedented gesture of financial support was that Poland had been of 'strategic importance in the stabilization and transformation of Eastern European states to market-oriented democracies, and in recognition of the contribution of the Polish armed forces to the Allied victory in World War II', and that Egypt had played an 'important role in the consolidation of a Gulf War coalition to expel Iraq from Kuwait' (US Treasury 2000).<sup>2</sup>

In Poland's case, the Paris Club, egged on by the United States, subsequently insisted that the Polish government obtain a comparable amount of debt forgiveness from its commercial bank creditors. The exposure of banks to Poland was half that of the Paris Club, but it was still quite large in absolute terms (almost \$15 billion), and the London Club expressed strong reservations about this politicization of the debt restructuring process, particularly as the extent of debt forgiveness demanded seemed to be unwarranted. Three years later, however, the banks caved in to the political pressure and agreed to a very generous debt deal under the Brady Plan that was deemed acceptable by the Paris Club. The multilateral agencies, meantime, did not depart from their tradition and granted debt forgiveness neither to Egypt nor to Poland.

In the late 1980s and throughout the 1990s, in fact, Paris Club operations began to move down two separate avenues. The first is the one I have detailed, applicable to middle-income or lower-middle-income countries, ineligible for debt forgiveness except in the two special cases just noted. The second is applicable to the lowest-income countries, which became eligible for progressively more generous amounts of debt reduction starting in late 1988. The reason official lenders moved down this second avenue is that mere reprofiling operations had exhausted the immediate cash-flow relief that could possibly be delivered to the poorest countries, and thus the creditors had to choose between increasing new commitments of foreign aid or agreeing to debt cancellation. Decisions on the extent of such forgiveness were made during various G7 summits, starting with one in Toronto in October 1988. 'Toronto terms' authorized for the first time a reduction of one-third of the debt of poor countries, and 20 countries benefited from them between 1988 and 1991. In December 1991, Paris Club creditors agreed to implement a new treatment on the debt of the poorest countries along 'London terms', which raised the allowable level of debt cancellation to 50%, and 23 countries benefited from these terms between 1991 and 1994.

In December 1994, the G7 governments agreed on still more debt forgiveness for lowest-income countries. These new 'Naples terms' raised

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<sup>2</sup>The US government went beyond the Paris Club agreement and reduced 70% of Poland's obligations plus 100% of Egypt's military debt.

the potential cancellation level to 67% of eligible credits, and 35 countries had benefited from these terms through early 2007. In November 1996, in the framework of the initiative for HIPC, the level of debt forgiveness was increased to 80% for the poorest countries with the highest indebtedness, and five countries qualified for these 'Lyons terms'. Then, in November 1999, the Paris Club creditor countries, again within the framework of the HIPC initiative and in the aftermath of the Cologne Summit, accepted a raise in the level of debt forgiveness up to 90% or more, and as of early 2007, 26 countries had benefited from 'Cologne terms'.<sup>3</sup> Finally, in mid-2005, the G8 gathering proposed that three multilateral institutions [the IMF, the International Development Association (IDA) of the World Bank and the African Development Fund] prepare themselves to cancel 100% of their debt claims on countries that have reached, or will eventually reach, the completion point under the Enhanced HIPC (September 1999).

However, progress on debt relief under the HIPC initiative has been painfully slow for two main reasons. First, official creditors have set eligibility criteria for debt cancellation according to evolving – and arguably incomplete and biased – standards as to what constitutes an unsustainable level of indebtedness. Initially, eligibility was based on two debt sustainability thresholds: the NPV of the public foreign debt had to be equivalent to more than 200% of annual exports, and yearly debt service had to represent at least 20% of export earnings. In the wake of the Enhanced HIPC, these eligibility standards were loosened – the NPV of the public external debt only had to be greater than 150% of annual exports – but the approach to debt sustainability did not change. Thresholds applicable to countries unusually open to foreign trade were likewise relaxed over time.<sup>4</sup>

It took many years for the World Bank and the IMF to react to criticism and adopt, in 2005, a new debt sustainability framework – a more comprehensive and forward-looking calculation, but also one more prone to bias and error. The new approach includes a determination of country-specific debt thresholds that considers domestic as well as external indebtedness. It varies depending on the quality of policies and institutions, an evaluation of economic vulnerability to external shocks, and the existence of a borrowing

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<sup>3</sup>The factual information cited in this and the prior paragraph was obtained from the website of the Paris Club, available at <http://www.clubdeparis.org/sections/termes-de-traitement/termes-de-traitements>.

<sup>4</sup>For countries with open economies (an export-to-GDP ratio greater than 40%) and substantial tax revenues (greater than 20% of GDP), having an NPV of public debt-to-tax revenues above 280% was an initial, alternative condition for eligibility. These thresholds were later lowered to above 30% (for exports-to-GDP), greater than 15% (for revenues-to-GDP), and above 250% (for debt-to-revenues).

strategy that minimizes the risk of debt distress. The new framework is nevertheless subject to criticism because of its reliance on a series of subjective judgements and economic projections (e.g. of debt repayment capacity and the likely growth of GDP, government revenues and export earnings), which are prone to optimistic biases on the part of official creditors. As a recent report by the World Bank's own Independent Evaluation Group (2006, p. 17) points out, GDP growth projections for 2005–10 included in HIPC debt sustainability analyses are more than twice their 1990–2000 averages, while export growth projections are 1.7 times their 1990–2000 averages. After all, besides being effectively governed by the creditor nations, the Bank and the IMF are creditors themselves to the poor countries, which results in debt relief needs 'being regularly calculated at a lower level than necessary' (Eurodad 2006a, p. 8; see also Northover 2004 and Arnone et al. 2005).

Second, official creditors have insisted that debt cancellation – no matter how badly needed – be conditioned on the application of stabilization measures and structural reforms over a period of many years. All that the Paris Club had expected of countries before granting them any debt relief was that they should have in place an agreement with the IMF specifying an agenda of stabilization and reform measures. The original HIPC initiative required countries not only to have successfully met the requirements of an IMF programme for three years in order to reach the so-called decision point, but to remain in compliance for a further three years in order to reach the 'completion point'. The Enhanced HIPC went beyond this to establish an additional conditionality: countries had to come up with a strategy for reducing poverty, including via higher government spending (as laid out in a 'Poverty Reduction Strategy Paper', or PRSP), and had to begin implementing it between the decision and completion points, subject to IMF/World Bank monitoring. In sum, the timetable for progress was no longer limited to three years but, rather, was stretched out for many more years. It is now called a 'floating timetable' – dependent on the nature and pace of progress as judged by the multilateral agencies. The conditionality attached to debt relief has thus become more comprehensive over time, and far more elaborate and subjective than envisaged by the original HIPC – never mind as practised for many years by the Paris Club (Dijkstra 2004).<sup>5</sup>

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<sup>5</sup>Slippage in the achievement of fiscal objectives, privatization targets and governance improvements are the most frequent causes of programme delay or breakdown (Jubilee Debt Campaign 2006). On the unacceptably high and rising number of conditions that poor countries must meet (e.g. 67 conditions per World Bank loan, on average), see Eurodad (2006b). However, the World Bank's count is an average of 12.5 conditions plus 32 non-binding benchmarks per operation in poor (IDA) countries, with conditions dropping steadily since 1999 and benchmarks rising sharply since 2002 (World Bank 2006, pp. 16–19).

Recent economic research suggests that, contrary to the immediate, massive and unconditional debt forgiveness granted by private creditors under the Brady Plan in the late 1980s and early 1990s, the piecemeal, delayed and highly conditional debt cancellation granted by official creditors in recent years has had little positive impact.<sup>6</sup> One empirical study examined the economic performance of countries that have been the recipient of HIPC-related relief, versus those that have not been included in this debt cancellation initiative, and concluded that the GDP growth rates of the HIPC countries have not been boosted.<sup>7</sup> Another assessment of the extent to which debt relief has been successful (using a database measuring the present value of debt relief for 62 low-income countries) found little evidence that debt relief has affected the level and composition of public spending in recipient countries, or that it has raised GDP growth, investment rates or the quality of policies and institutions among recipient countries (Depetris Chauvin and Kraay 2005).

One reason for disappointment is that official debt relief has been provided in lieu of grants or new concessional loans, such that there has been no significant increase in the net quantity of resources given to the HIPC countries (Arslanalp and Blair Henry 2006, pp. 9–10). Another reason is that, in far too many cases, improved repayment capacity in the wake of debt cancellation has been offset by subsequent increases in debt due to new borrowing. In 11 out of 13 HIPC countries with the necessary data, the key indicator of external debt sustainability deteriorated as they reached their completion point, and in eight of them the latest ratios again exceed HIPC thresholds (World Bank Independent Evaluation Group 2006, p. 33).

Yet another explanation for disappointing results is that, because the HIPC initiative forces poor countries to reallocate the resources freed from debt service in favour of spending on poverty reduction programmes, countries must still raise the same amount of budgetary revenues as they did before receiving 'relief'. Indeed, according to the latest estimates by the IMF and World Bank, the 29 HIPCs that reached the decision point by mid-2006 had experienced a drop in debt-service payments equivalent to about 2% of their GDP between 1999 and 2005. However, their poverty-reducing expenditures had increased by almost 3% of GDP during that same time period (Development Committee 2006, p. i). In other words, HIPC does not deliver any cash-flow savings; it enables poor countries to increase govern-

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<sup>6</sup>'In the 1980s, debt relief under the 'Brady Plan' helped to restore investment and growth in a number of middle-income developing countries. However, the debt relief plan for the HIPC launched by the World Bank and the IMF in 1996 has had little impact on either investment or growth in the recipient countries' (Arslanalp and Blair Henry 2006, p. 1).

<sup>7</sup>'Debt stock relief [under the HIPC] ... has no influence on growth independent of the sample used' (Hepp 2005, p. 2).

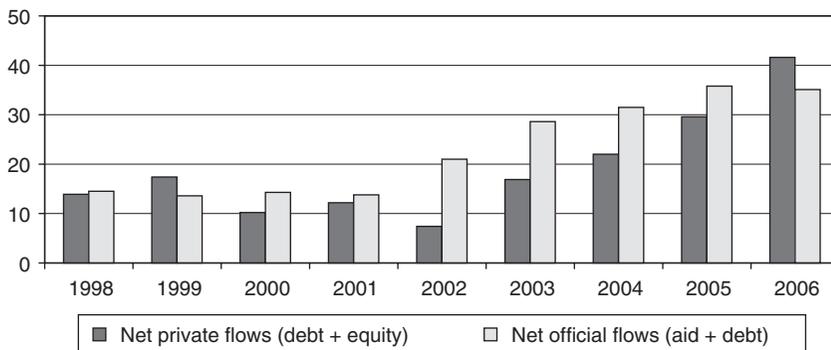
ment spending on programmes favoured by donor governments – as opposed to saving the proceeds or spending them on programmes preferred by local policy makers (Burnside and Fanizza 2004, pp. 1–4).

#### IV. Enter the Bondholders

From the mid-1990s until the present, bond and equity investors, in addition to commercial banks and private sector suppliers, have become the dominant source of financing for developing countries. The rise of large-scale bond issuance on the part of governments and corporations in the emerging markets was facilitated by the advent of the Brady bonds, which were gradually sold to institutional investors by the commercial banks (who were the original holders). The increasingly active ownership and trading of these Brady bonds by risk-prone hedge funds, and later on by conservative mutual and pension funds, opened up a new investor base willing to take on credit exposures to middle- and lower-middle-income countries – a bet on their potential economic success. As concerns the buildup of portfolio and strategic equity investments in the emerging markets, these flows were facilitated by the privatization of major utilities, industries and banks in many of the developing and transition countries, and by these countries' generally welcoming attitude towards foreign investment. Even in sub-Saharan Africa, by far the world's poorest region, in recent years net private flows of debt and equity finance have been just as substantial as net official flows of foreign aid and trade credit (see Chart 2).

When various developing countries faced financial difficulties in the second half of the 1990s and also earlier this decade, they kept turning to the IMF for guidance and financial support. But afterwards their top priority was to find

**Chart 2:** External financing to sub-Saharan Africa (\$ billions)



Source: World Bank, *Global Development Finance 2006* (Washington, DC: World Bank, 2007), p. 179.

ways of restructuring their bonded debt, and not only their obligations to commercial banks. Because of the relative insignificance of debts falling due to official creditors, obtaining debt relief from the Paris Club became an option that was often bypassed. For example, during the Asian currency and debt crisis of 1997–98, Malaysia, the Philippines, South Korea and Thailand never sought debt relief from their official creditors. Similarly, Mexico, Brazil and Uruguay did not turn to the Paris Club for any debt reprofiling in the wake of their financial troubles in 1994–95, 1998–99 and 2002–03, respectively – and neither did Turkey in 2000–02. These countries' bondholders and commercial bank creditors did not even attempt to precondition the debt refinancing and/or forgiveness they granted five of these countries (Brazil, Korea, Thailand, Turkey and Uruguay) to the simultaneous attainment of comparable debt relief from official bilateral – never mind multilateral – creditors, given the large infusions of new financing on the part of the IMF and other official lenders (Roubini and Setser 2004, pp. 30–1, 149–55).

The gesture was not reciprocated by the Paris Club when dealing with those developing countries that did knock at its door seeking debt relief during the past decade. For instance, when countries as diverse as Indonesia (1998), Pakistan (1999), Russia (1999) and the Dominican Republic (2004) encountered financial difficulties and reached out to their official creditors, the debt relief they obtained from the Paris Club was conditioned on securing comparable relief from their bankers and bondholders. This was true even when debt to private creditors was small or was not yet falling due, as in the cases of Pakistan and the Dominican Republic. In return for a Paris Club debt rescheduling of payments due in 1999–2000 (along Houston terms), Pakistan was forced to reschedule three Eurobonds maturing during 1999–2000 even though the amounts involved were relatively small. And in exchange for a Paris Club debt rescheduling of some arrears and payments due in 2004 (along Classic terms), the Dominican Republic was required to reschedule a Eurobond maturing in 2006 and another one falling due in 2013.<sup>8</sup> In other instances, as in those involving the Ukraine in 1998–2000 and Ecuador in 1999–2000, it was the IMF rather than the Paris Club that conditioned its financial assistance to the achievement of debt relief from private creditors. By the time Ukraine and Ecuador came calling on the Paris Club (in July 2001 and September 2000, respectively), the debt restructuring deed had already been done.

Contrary to a common assumption in G7 policy making and academic circles at the start of the decade – that bondholders were too atomized and disorganized to help a sovereign debtor in distress restructure its debt obligations in a timely manner – the absence of a supranational sovereign

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<sup>8</sup>The Paris Club would later also agree to reschedule payments due in 2005.

bankruptcy mechanism did not delay, never mind impede, several workouts that have taken place in the past decade.<sup>9</sup>

During the period from 1998 until 2003, the governments of Ecuador, Moldova, Pakistan, Russia, Ukraine and Uruguay were all able to restructure their commercial bank and/or bonded debt – and did so at a progressively faster pace, as issuers and investors became accustomed to the mechanics of bond restructurings. Sovereign debtors obtained meaningful debt-service relief and even sizeable debt forgiveness through the use of exchange offers, often accompanied by bondholder exit consents that encouraged the participation of as many investors as possible in take-it-or-leave-it settlements. Rather than amending bond covenants, the exchange offers typically entailed the debtor government presenting its private creditors with a menu of voluntary options, such as accepting new bonds for a fraction (e.g. 60%) of the principal owed but paying a market interest rate, or else new bonds for the original principal but paying a concessional interest rate. Experience demonstrated that neither the threat of litigation nor actual cases of litigation derailed these debt relief operations, which involved everyone from large, institutional investors to small, retail bondholders throughout the world (IMF 2006d).

Since 2003, there have been four other successful sovereign debt restructurings involving small countries in Central America and the Caribbean: Belize, Dominica, Grenada and the Dominican Republic. In the first three instances, commercial banks and bondholders have been prevailed upon to grant substantial debt forgiveness – about 20% on an NPV basis in the case of Belize, and 40–50% in Dominica and Grenada.

In another instance of treatment that was anything but comparable, the Paris Club of official creditors has agreed only to a debt rescheduling along Classic terms for Grenada (2006), and has not been called upon to offer any debt relief to Belize or Dominica. In the case of the Dominican Republic, as mentioned previously, the country turned first to the Paris Club and it consented to a debt restructuring along Classic terms (2004–05) – but then the country was obligated to restructure payments to commercial banks and bondholders. The multilateral agencies, for their part, have provided various degrees of support to these countries. For instance, Dominica and Grenada are sufficiently poor that they qualified for concessional lending from the

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<sup>9</sup>According to the then first deputy managing director of the IMF, and despite plenty of evidence to the contrary, a new approach to sovereign debt restructuring was 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 (2002, p. 8).

IMF under its Poverty Reduction and Growth Facility (PRGF); the Dominican Republic borrowed from the Fund under its normal Stand-by Facility; and Belize decided to make do without any IMF or World Bank financial support. Belize is therefore an interesting example of a country that is being 'bailed out' exclusively by private-sector creditors, since official bilateral and multilateral creditors account for 40% of the government's external debt, but they have not provided financial support (IMF 2006e, pp. 48–53).

A relatively new phenomenon, which also exemplifies the difference in the contribution made by private versus official creditors to the resolution of debt overhang problems, is the prepayment of debt that three governments (Nigeria, Peru and Russia) made to the Paris Club during 2005–06. In the summer of 2005, basking in the glow of their oil bonanza, the Russian authorities decided to make a first prepayment of \$15 billion to clear debts to official bilateral creditors, and a year later the country repaid the remainder of its Paris Club debt – \$22 billion in cash. In the second half of 2005, the Paris Club also accepted an offer made by the government of Peru to prepay up to \$2 billion in maturities of its debt falling due during 2005–09, using the proceeds from financing obtained in the world capital markets.

In October 2005, the Paris Club reached a long-awaited deal with the government of Nigeria, whereby the country, enjoying (like Russia) a major oil-related windfall, first cleared its payment arrears in exchange for a 33% cancellation of eligible debts. Then, in March 2006, Nigeria paid other amounts coming due in exchange for a further cancellation of 34% on eligible debts, buying back remaining obligations. In total, the deal allowed the country to obtain debt cancellation estimated at \$18 billion (including past-due interest), representing about 60% of its debt to the Paris Club, in return for making cash payments amounting to \$12.4 billion.<sup>10</sup> Needless to say, Paris Club creditors did not insist that these three countries should treat their private creditors in a comparable manner, and prepay them or otherwise compensate them for debt forgiveness granted in earlier years. As noted earlier, 'comparability of treatment' is a highly discretionary, one-way street.

## V. Some Contrasting Individual Cases

The cases of Bolivia, Nicaragua, Ecuador and Argentina, with which this author had some involvement, bring home the difference between how private and official creditors have treated – and have been treated by –

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<sup>10</sup>Paris Club press releases dated 15 June 2005 (Peru), 20 October 2005 (Nigeria) and 23 June 2006 (Russia), available at [http://www.clubdeparis.org/en/press\\_release/page\\_commupresse.php](http://www.clubdeparis.org/en/press_release/page_commupresse.php)

Table 1: Comparison of Recent Sovereign Debt Restructurings

	Argentina 2005	Dominican Republic 2005	Ecuador 2000	Pakistan 1999	Russia 1998–2000	Ukraine 1998–2000	Uruguay 2003
Per capita income (\$)*	13,920	7,150	3,363	1,826	6,592	3,841	8,280
Scope (\$ billions)	81.8	1.1	6.8	0.6	31.8	3.3	5.4
Number of bonds	152	2	5	3	3	5	65
Jurisdictions involved	8	1	2	1	1	3	6
Months in arrears	41	None	10	2	18	3	None
Minimum participation set	No	No	Yes	Yes	Yes	Yes	Yes
Recognition of interest arrears	Partial	Yes	Yes	Yes	Yes	Yes	N/A
Principal forgiveness	Yes	No	Yes	No	Yes	No	No
'Haircut' on Discount bond (%)	66.3	0	40	0	37.5	0	0
Lowered coupons	Yes	No	No	Yes	No	Yes	No
Extended maturities	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Participation rate (% of eligible)	76	97	97	95	98	95	93

Source: IIF, IMF, World Bank, author's calculations.

Notes:

\* Adjusted for purchasing power; data correspond to year(s) indicated of debt restructuring.  
N/A, not applicable.

governments in serious financial trouble. These developing countries offer an interesting variety because they span the range of income categories identified by the World Bank and other multilateral agencies: low income (Nicaragua), middle income (Bolivia and Ecuador), and upper income (Argentina).

### *A. Bolivia*

In 1988, following many years of debt-servicing difficulties, the government of Bolivia retired most of its commercial bank debt through a buyback, with creditors writing down nearly 90% of what the government owed them. In 1992, under the aegis of the Brady Plan, the remaining private creditors were given the option to accept a cash buyback incorporating an 84% discount; a short-term bond with a similar degree of forgiveness convertible on maturity into local assets at a premium; or else a 30-year, collateralized bond bearing no interest. And a year later, in 1993, the government offered yet another debt buyback, funded by grants from the World Bank's IDA and various donor governments, whereby virtually all remaining commercial creditors tendered their debts and accepted a loss of 84% of principal. As a result, Bolivia's government debt to private creditors, which had exceeded \$1 billion back in 1980, accounting for half of its external obligations, dropped to less than \$75 million by the mid-1990s, equivalent to not even 2% of the total (World Bank 2001). Private creditors had accepted huge, upfront losses – but at least they were no longer responsible for Bolivia's remaining debt woes.

Bolivia became eligible for debt relief from official bilateral and multilateral creditors under the original HIPC initiative in September 1998, a full decade after private creditors began to forgive their share of the country's debt. Bolivia obtained less than \$30 million in official debt forgiveness in 1998, an amount which increased to almost \$90 million per annum in 1999–2001, and subsequently, having qualified under the Enhanced HIPC initiative, to an annual average of about \$160 million during 2002–04 – the equivalent of around 1.5% of annual GDP. However, despite this steady debt relief, and largely because of growing budgetary deficits as a result of rising government spending, Bolivia's public-sector debt increased from the equivalent of 60% of GDP in 2001 to 71% of GDP (some \$6.7 billion) in 2005. It has dropped since then because of substantially higher oil-related revenues – not because of official debt relief on the instalment plan (Fundación Jubileo Bolivia 2005; IMF 2006b). The country's external debt-service payments, which averaged 4.3% of GDP per annum during 2003–05, are expected to average 2.6% of GDP during 2006–08 after HIPC and MDRI-related relief (Development Committee 2006, p. 66).

## *B. Nicaragua*

In 1995, in a buyback of commercial bank debt funded by grants from the World Bank's IDA and various donor governments, most private creditors forgave 92% of what the government of Nicaragua owed them (\$1.1 billion). Foreign commercial banks had accounted for more than 15% of the government's external debt, but after this immediate debt forgiveness they came to represent a mere 3% of the total. Earlier that year, official bilateral creditors in the Paris Club had agreed to cancel up to 67% of eligible debts under Naples terms, but the multilateral agencies provided no debt relief – except for the Central American Bank for Economic Integration (CABEL), which at least agreed to reschedule its loans to Nicaragua. The government's external debt consequently dropped from nearly \$12 billion in 1994 – by far the highest debt burden among developing countries, equivalent to more than nine times GDP – to \$6 billion by 1996, a still excessive 375% of GDP (World Bank 2001, Table 1).

Nicaragua never became eligible for debt relief under the original HIPC initiative, but in the event it reached its completion point under the Enhanced HIPC in January 2004. The government's external debt is presently being reduced from over \$7 billion to about \$3 billion (representing a high but tolerable 65% of GDP) thanks to debt forgiveness by bilateral and multilateral lenders. And yet, its external debt-service payments, which averaged 2% of GDP per annum during 2003–05, are expected to remain at that level during 2006–08 despite HIPC and MDRI-related relief (Development Committee 2006, p. 67). Nicaragua is also having trouble obtaining all of its HIPC relief because it has 23 non-Paris Club official creditors, more than double the average of other HIPC countries, and some of them have refused to grant debt relief (e.g. China, Iran, Libya and Taiwan). One of them (Libya) has even resorted to litigation, demanding full payment (Development Committee 2006, p. 25).

## *C. Ecuador*

In 1995, following many years of debt-servicing difficulties, the government of Ecuador asked private creditors to grant either principal or interest forgiveness as part of a comprehensive Brady Plan restructuring of nearly \$8 billion in commercial debt, and also to write off a portion of past-due interest. Most creditors (60%) accepted the choice of 30-year Discount bonds with a 45% 'haircut' on the principal owed, while the rest acquiesced to 30-year bonds with highly concessional coupons delivering an equivalent amount of relief on an NPV basis.<sup>11</sup> As an immediate result, Ecuador's public external debt was reduced by \$1.8 billion, or 17% of the total.

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<sup>11</sup>Other shorter-maturity bonds were also issued, for example to cover a portion of past-due interest, and Ecuador paid a small amount of arrears in cash.

When Ecuador experienced acute fiscal 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 stopped paying its private creditors and obtained debt forgiveness – again. Ecuador thus had the dubious honour of becoming the first country to default on its Brady bonds, and also one of the first (at least in contemporary times) to default on Eurobonds. In mid-2000, the government proposed a complex debt relief operation whereby the various bonds in default were subjected to ‘haircuts’ ranging from 19% (Brady Par bonds) to 47% (the Eurobond maturing that year) before being exchanged for a mix of new Eurobonds (maturing in 2012 and 2030) and some upfront cash to help cover arrears. The deal as accepted resulted in a 40% cut in the face value of Ecuador’s debt, and in cash-flow savings of about \$1.5 billion over the first five years. In the wake of this debt relief, obligations to bilateral and multilateral creditors came to account for the majority (60%) of the government’s remaining external indebtedness.

In sharp contrast, official bilateral and multilateral lenders have never agreed to any debt reduction for Ecuador. The country appealed for debt relief to the Paris Club time and again – in four instances during the 1980s, and also in 1992, 1994, 2000 and 2003 – and while it was deemed to be insolvent enough to deserve write-offs from private creditors on the two occasions noted (1995 and 2000), it was considered insufficiently needy to deserve write-offs from official creditors even once. At the beginning of the 1990s, the Paris Club was owed about \$2 billion, or one-fifth of Ecuador’s public-sector external debt, but it agreed merely to reschedule payments falling due in the short term according to Houston terms – namely, with some reduction in interest payments. The last rescheduling by official bilateral creditors, in mid-2003, involved stretching out a mere \$81 million falling due in the year to 31 March 2004.<sup>12</sup> The multilateral agencies, for their part, have neither rescheduled nor reduced any of the country’s debt, and they have provided little or no net financing to Ecuador. In fact, from 2001 to 2004, amortization payments by Ecuador’s government to official bilateral and multilateral creditors actually exceeded disbursements received from those same creditors (IMF 2003, 2006a, p. 34).

#### *D. Argentina*

The largest and potentially most complex default the world has ever known was declared by the government of Argentina in December 2001. A punishing, unilateral restructuring offer was presented to bond investors three

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<sup>12</sup>See various Paris Club press releases relating to Ecuador, available at [http://www.clubdeparis.org/en/press\\_release/page\\_commupresse.php](http://www.clubdeparis.org/en/press_release/page_commupresse.php)

years later (January 2005), which was accepted under duress by 76% of total bondholders. The government thus obtained principal forgiveness estimated at 56% of affected debt, managing to inflict NPV losses of around 75%. Eligible for the massive bond exchange were 152 different securities amounting to a total of \$82 billion, including a relatively small amount of past-due interest (accrued to end-2001) – because interest arrears after that point were not recognized. Eleven new securities were offered to participating investors. They ranged from Par bonds, which were not subject to a haircut on nominal principal but paid just a token amount of interest and had a final maturity of 35 years, to Discount bonds with a principal reduction of 66% and better terms otherwise, designed to mete out approximately equal NPV losses (IMF 2006d, pp. 12, 14, 48–9).

Argentina's insistence on such massive debt relief is without precedent in its own checkered financial history, and also in comparison with the debt relief obtained by other upper-middle-income countries – the likes of Chile, Mexico, South Africa or Turkey – in decades past. It can only be compared with the large-scale relief obtained by much poorer countries such as Bolivia or Nicaragua, as detailed above, or by other HIPCs. Adding insult to injury, Argentina's fiscal performance and international reserves, and most economic and social indicators, have since fully recovered from their low point in 2001–02 (IMF 2006c). The government has remained current in its obligations to the multilateral lending agencies, even though they have greatly diminished their disbursements to the country. It has also prepaid all of its debt to the IMF: a whopping \$10 billion payment made at the end of 2005, following principal payments of about \$13 billion made earlier. And while Argentina has been in default to the bilateral agencies represented by the Paris Club (for more than \$6 billion, including interest arrears, as of end-2006), all that the government is reportedly expecting is an eventual rescheduling under Classic terms.<sup>13</sup>

Arguably, Argentina's bondholders could have fared much better if official bilateral and multilateral creditors, led by the United States and other G7 governments, had stood up to this rogue sovereign debtor and had insisted on fair treatment for private creditors. Instead, they essentially sided with Argentina, or at best turned a blind eye to its aggressive designs, thereby encouraging the authorities in Buenos Aires to make mincemeat out of its bondholders. To begin with, the Bank for International Settlements (BIS), the Basle-based central banks' central bank, allowed itself to be used as a safe

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<sup>13</sup>In early 2007, Argentina reportedly offered the leading Paris Club governments to pay all outstanding principal and past-due interest over a relatively short period of ten years. See Argentina's *Clarín* newspaper, 'Club de Paris: la oferta argentina es pagar la deuda en 10 años y sin quita', 14 January 2007.

harbour for Argentina's hard-currency assets, because while on deposit there they are out of attachment range from bondholders who have obtained judgements against the government in various courts. Second, the multilateral lending agencies were actually supportive of Argentina via a series of new loans granted by the IMF, the World Bank and the Inter-American Development Bank, especially during 2003 and the first half of 2004. This despite the fact that the IMF has had a policy of lending to a government in default only when it is pursuing 'appropriate policies' and when it is making 'a good faith effort to reach a collaborative agreement with its creditors' (IMF 2002).

Argentina also won an important gesture of political support in the form of *amicus curiae* briefs filed by the US government and the Federal Reserve in US courts in January 2004. The government in Buenos Aires succeeded in persuading US authorities that the international payments system was at risk from the potential application of a legal clause (*pari passu*), which had been used by creditors against the governments of Peru and Nicaragua.<sup>14</sup> And then, while Argentina was crafting its request for debt forgiveness (during 2004), the IMF declined to insist upon overwhelming acceptance of whatever debt restructuring proposal the country would put forth to its creditors. Doing so would not have been unusual for the Fund, and it would have put pressure on Buenos Aires to come up with a less punishing proposal – or to have added some last-minute 'sweeteners' to maximize bondholder acceptance (Porzecanski 2005, pp. 327–31).

## VI. Lessons from Recent Debt Crises

In sum, one of the clearest lessons from the past couple of decades of sovereign financial crises is that institutional and retail bondholders, as well as commercial and investment bankers in the United States, Canada, Europe and Japan, have developed a commendable track record in dealing with sovereign debt problems. They have helped to resolve innovatively, expeditiously and generously the multiple cases of sovereign over-indebtedness in which they have been involved in various parts of the world – despite, or possibly because of, the absence of a supranational bankruptcy regime for sovereign debt. The official development community, in contrast, cannot make a similar claim: time and again, the bilateral and multilateral lending agencies have dragged their feet in accepting loan losses and granting debt forgiveness – whether to over-indebted middle-income nations or to the

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<sup>14</sup>The US government and the Federal Reserve would also go on to file *amicus* briefs on the side of Argentina in April 2006, in support of a US court decision to vacate an order of attachment against certain funds belonging to the Central Bank of Argentina held at the Federal Reserve Bank of New York, which was then on appeal.

poorest countries in the world. More often than not, they have been – and remain – part of the sovereign indebtedness problem, rather than part of its constructive alleviation. And yet, this is one lesson that does not come through in the 2006 crop of scholarly books on sovereign debt issues.

The volume by Borensztein, Levy Yeyati and Panizza, to begin with, provides a comprehensive, factual analysis of the nature and evolution of sovereign debt in developing countries, with rich detail on the most crisis-prone region of them all – Latin America. Its main conclusion is that the structure of the debt issued by governments, coupled with the inherent volatility of the region's economies, is what has put Latin America especially at risk of periodic solvency and liquidity crises.

The authors' recommendations make eminent sense. The first one is that governments in developing countries put in place a defensive framework for fiscal policy decisions that prevents the reckless accumulation of public debt. This includes fiscal rules to minimize the impact of election cycles and other political forces on public spending; 'rainy day' funds that save part of the proceeds from commodity price booms, such as the one under way at present; and more transparency and improved management of contingent liabilities (arising from public works, state-owned companies or the banking system) and risky currency mismatches. The book then rightly urges governments in Latin America and elsewhere to continue to improve the structure of their liabilities away from reliance on foreign-currency-denominated debt by fostering the kind of domestic capital markets that can help minimize dependence on fickle foreign bank lenders and investors. It also wisely recommends greater issuance of contingent debt, such as catastrophe bonds with equity-like features providing for lower payments in the event of adverse shocks like recessions, commodity price collapses and natural disasters. In short, the book is a clarion call for emerging-market governments to heed the lessons of history and resist the temptation to build up and then manage their liabilities in a 'penny-wise and pound-foolish' manner, as so many did until recent years. It makes a valuable contribution to the literature on the *prevention* of future debt crises.

The collection by Jochnick and Preston, in contrast, is quite eclectic and mainly concerned with hastening the *resolution* of sovereign debt problems. Dedicated by the empathetic editors 'to the millions of poor who suffer the burden of debts they had no part in creating', the volume includes 14 contributions mostly from pure academics and debt-relief campaigners who passionately advocate blanket, unconditional debt forgiveness for developing countries.<sup>15</sup> The inheritance of indebtedness is described by

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<sup>15</sup>This author contributed one of the 14 chapters in the Jochnick–Preston volume – and one of the token few that did *not* advocate debt forgiveness as a panacea.

two of the most hyperbolic authors as, respectively, 'the worst plague in human history' and 'the leading cause of human rights violations in the developing world'. Several chapters address the ethical, political and legal aspects of 'odious' or otherwise illegitimate Third World debt. The book will thus be of particular interest to those searching for the holy grail of poverty eradication through massive and unconditional debt relief.

The volume authored by Sturzenegger and Zettelmeyer is a dispassionate, analytical review of recent restructurings of sovereign obligations to private creditors – mainly bondholders during 1998–2005. The description of how the governments of Russia, Ukraine, Pakistan, Ecuador, Argentina, Moldova and Uruguay went about obtaining debt relief is based on publicly available information (mostly declassified IMF reports). Therefore, readers interested in the 'inside story' of, say, why the Paris Club broke with precedent and forced the authorities in Pakistan to restructure their Eurobond debt in 1999 despite the bonds' traditionally sacrosanct seniority, or how the government of little Uruguay went about overcoming the IMF's demand that it should impose major, Argentina-style losses on bondholders in 2002, will have to wait for a more journalistic or historical endeavour.

The authors' original, technical contribution is the painstaking decomposition of each country's debt dynamics (namely, quantifying the contribution that currency devaluations, economic collapses, higher interest rates or fiscal profligacy each made to eventually unsustainable debt ratios), plus the detailed computation of the losses ('haircuts') that bondholders had to swallow in each instance. The book also includes useful overview chapters summarizing the economic fundamentals behind most debt crises, the unique legal issues involved in bond restructurings, the choices facing policy makers trying to manage a payments crunch, and the alternatives for reforming the 'international financial architecture'.

While excellent at surveying the literature and discussing the dilemmas encountered and the many policy choices available, the authors frustrate by failing to endorse – never mind advocate – any particular moral compass, policy stance, negotiating strategy or reform alternative. The chapter meant to offer practical guidance to policy makers in developing countries is unlikely to be regarded as helpful by any decision-maker – especially one operating under cash-flow duress. For example, the authors write, 'it may sometimes make sense to attempt to avoid a default even when the chances of success are modest' (p. 247). And 'Government debt on the balance sheets of the [domestic] banks may require designing the debt restructuring so that it maintains the viability of the financial sector' (p. 254). Even the eminently wise counsel that policy makers should seek first-rate legal and financial advice is qualified by the authors, because dealing with domestic or large creditors 'can be handled by the government itself' (p. 268). In sum, despite the promise

explicit in the book's title, the lessons from a decade of debt crises for the most part are *not* distilled by Sturzenegger and Zettelmeyer – a shortcoming that motivated my attempt to derive at least one clear lesson myself.

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