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A BLUEPRINT FOR A SOVEREIGN DEBT FORUM

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Richard Gitlin and Brett House



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ABOUT THE AUTHORS



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Richard was a co-founder of the American Bankruptcy Institute (ABI), which began operations in 1982; he went on to serve as president of the ABI during 1987–1992. Richard also participated in the founding of the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL), which brings together 44 national-level insolvency membership associations, and for which he also served as president during 1991–1993. Additionally, Richard was chair of the American College of Bankruptcy, an honorary association of bankruptcy and insolvency professionals, during 1995–1997.

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ABOUT THE PROJECT

The “Managing Severe Sovereign Debt Crises” project is focussed on the articulation of a set of incremental policy proposals that could meaningfully improve efforts to deal with sovereign crises and restore troubled sovereigns to market access and sustained growth. Among these, the Sovereign Debt Forum (SDF) would provide a centre for continuous improvement of the processes for dealing with financially distressed sovereigns and a venue for proactive discussions between debtors and creditors to reach earlier and more effective understandings on the treatment of specific sovereign crises. More broadly, the project additionally aims to develop a pragmatic reform agenda, whereby these proposals can be combined in a complementary fashion that provides a feasible plan by which tangible progress can be made on their implementation.

The project is intended to build on the current revival of interest in sovereign crisis prevention, abatement and resolution driven by the 2008 financial crisis and its after-effects in Europe. Since the rejection of the International Monetary Fund’s Sovereign Debt Restructuring Mechanism (SDRM) proposal in 2003, the international discussion on sovereign crisis workouts and debt restructuring has been at an impasse between proponents of statutory frameworks, such as the SDRM, and those favouring decentralized, ad hoc, market-based or “voluntary” approaches centred on wider use of collective action clauses (CACs) in debt contracts. The project is driven by an assessment that the global community can transcend this impasse through the development of a broadly based consensus around a set of politically realistic, incentive compatible, effective reforms that can be implemented without negotiation of formal international treaties.

The project’s proposals and analysis will be detailed in a series of policy briefs and papers. These will be discussed in a range of meetings across geographies, markets and institutions; and they will be published online and disseminated to international political processes and governments. Over the course of the project, an edited volume will be produced that brings together the project’s work with proposals tabled by other researchers and policy makers.

ACRONYMS

ABI	American Bankruptcy Institute
APEC	Asia-Pacific Economic Cooperation
CAC	collective action clause
CIEPR	Committee on International Economic Policy and Reform
DFID	Department for International Development (UK)
DSA	debt sustainability analysis
EEAG	European Economic Advisory Group
EITI	Extractive Industries Transparency Initiative
ESM	European Stability Mechanism
FSB	Financial Stability Board
G8	Group of Eight
GATT	General Agreement on Tariffs and Trade
IIF	Institute of International Finance
IMF	International Monetary Fund
INSOL	International Association of Restructuring, Insolvency & Bankruptcy Professionals
MDTF	Multi-Donor Trust Fund
NPV	net present value
OECD	Organisation for Economic Co-operation and Development
PWYP	Publish What You Pay
SDF	Sovereign Debt Forum
SDAF	Sovereign Debt Adjustment Facility
SDRM	Sovereign Debt Restructuring Mechanism
UNDESA	UN Department of Economic and Social Affairs
WTO	World Trade Organization

EXECUTIVE SUMMARY

This paper outlines a blueprint for the creation of a Sovereign Debt Forum (SDF). The SDF would provide a centre for continuous improvement of the processes for dealing with financially distressed sovereigns and a venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises.

The paper details the limitations of the status quo that has prevailed more or less unchanged since 2003: the world has been caught between the spectre of a rejected proposal for a statutory Sovereign Debt Restructuring Mechanism (SDRM) and a collective action clause (CAC)-based ad hoc approach to voluntary, market-oriented restructurings that does not produce optimal results. This impasse has remained unresolved owing, in part, to a fundamental misdiagnosis of the key pathologies at work in episodes of sovereign financial distress. Contrary to fears that sovereigns are inclined to default gratuitously on their debt obligations owing to the challenges posed by enforcement of these contracts, recent history shows that sovereigns tend to delay restructuring their debt and, when they do pursue a debt treatment, they are often insufficiently ambitious in seeking to produce a debt burden that is sustainable. In this context, policy reforms should be concentrated on reducing the impediments to addressing sovereign financial distress in a proactive, predictable and consensus-driven fashion.

Mindful that internationally agreed statutory approaches currently have little support among country authorities, but recognizing that a pathway needs to be found to meaningful change, the paper extracts lessons in fashioning pragmatic, practical reforms from recent efforts to improve corporate insolvency and informal interstate initiatives on bilateral sovereign debt, anticorruption and trade liberalization. Drawing on these examples, the paper outlines a proposal for a non-statutory, incorporated, non-profit, membership-based SDF that would provide an independent standing body to research and preserve institutional memory on best practice in sovereign debt restructuring, while at the same time creating a venue to facilitate early engagement among creditors, debtors and other stakeholders when sovereigns encounter trouble. The proposed SDF would not require complex treaty negotiations to be enacted and it would complement existing institutions and processes to produce more efficient and effective resolution of sovereign financial distress when it arises by engaging both troubled and stable sovereigns in continuous dialogue with creditors and official institutions. By fomenting early action, the SDF would aim to prevent scenarios where deep debt restructuring becomes the inevitable resolution of severe sovereign crises.

The paper closes by enumerating an annotated menu of non-statutory, incremental, but potentially powerful reforms complementary to the SDF that could be pursued individually or in groups to address *ex ante*, *in medias res* and *ex post* impediments to reaching better sovereign debt treatments. There is an opportunity now to forge a concerted agenda to implement these proposals. Policy makers could opportunistically pick and choose from this agenda: a variety of sequencings and groupings of these reforms are internally consistent and complementary. None require unanimity across countries or concurrent, lockstep action. But mutual support among implementing countries could make concerted action easier and more effective.

The 2008 crisis has focussed fresh attention on the ways in which we deal with sovereign financial distress. Yet, we know from past crises that impulses for reform tend to wane as financial conditions normalize. Early action to implement the SDF proposal outlined in this paper would prepare us to handle the next crisis before it comes.

INTRODUCTION

Sovereign debt distress has been a regular feature of both ancient and modern economies. From the first sovereign default by a handful of Greek city states in the fourth century BC onward to Greece's 2012 debt exchange and buyback, sovereigns have periodically encountered difficulties in servicing their debt. Sovereign financial distress has tended to be driven by unexpected shocks that undermine governments' capacity to pay their bills, mistakes in debt management that lead to unpayable spikes in debt service even when underlying long-run solvency remains intact and overborrowing compared with a country's ability to generate a consistent stream of future surpluses.

Sovereign debt crises may be the product of policy errors and flaws in the design of public institutions, but they are just as easily generated by developments that are either nominally or substantially outside a government's control. Sudden disruptions concentrated in the real sector or the financial sector may force governments to assume so many private sector liabilities that a sovereign's previously clean balance sheet becomes unsustainable. Similarly, rapid exogenous developments in currency markets, the external current account or the external capital account can, depending on the structure of a sovereign's debt stock, render otherwise prudent and sustainable country authorities either illiquid or insolvent.¹

Despite the regular incidence of sovereign debt crises throughout history, there is a lack of any formal legal or policy framework to guide an optimal treatment of sovereign debt when servicing it falls into doubt. An ideal institutional structure for handling sovereign debt crises would allow for a distinction to be made between transitory liquidity problems and fundamental solvency problems, and to identify, prescribe and implement appropriate solutions in a timely fashion.

The line between illiquidity and insolvency in sovereign debt crises will likely always be blurred, state contingent and a matter of judgment. As a result, the aim should be to create institutions for handling and resolving sovereign debt crises that are robust to this ambiguity rather than building structures that attempt to explain it away. A regime for sovereign debt workouts that brings debtors and creditors together on a proactive basis to address temporary liquidity problems before they undermine a country's fundamental solvency should be pursued. Where solvency has already been lost, an optimal regime would facilitate an early treatment of a distressed sovereign's debt so that the country can quickly return to investing in growth rather than pursuing an indefinite period of immiserating austerity.

1 See Lane (2012) on these transmission mechanisms in the recent euro-zone crisis.

The absence of such a framework reflects, in part, a view that sovereign crises should be costly in order to discipline governments to pay their debts (Eaton and Gersovitz 1981). Sovereign debt contracts are inherently difficult to enforce because government assets are generally shielded by sovereign immunity, and the bulk of these assets usually lie within the sovereign's own legal purview. Additionally, the sovereign debtor can usually rewrite its own domestic debt contracts and carve out from attachment any assets under its jurisdiction. In this context, the economic costs associated with default may be both the only assurance creditors have that they will be repaid and the only incentive that debtors have to honour their debts.²

RECENT HISTORY OF SOVEREIGN DEBT CRISES

Each recent episode of sovereign debt crisis has elicited appropriately different responses to the perceived challenge of facilitating a workout, while at the same time preserving incentives for sovereigns to service their obligations.³ The Latin American debt crisis of the 1980s led first to the partially implemented Baker Plan and then the successful Brady Plan. Whereas the Baker Plan sought to provide fresh financing to Latin American debtors in return for promised structural reforms, the Brady scheme offered a menu of options by which creditor banks could remove their loans to Latin American governments from their balance sheets. Brady succeeded where Baker failed to be fully implemented because Brady more effectively balanced debtor and creditor interests by letting them choose the treatments that best suited their respective needs.

The post-Brady crises in Mexico (1995), East Asia (1997) and Russia (1998), where the collapse of fixed exchange rate regimes led to both sovereign and private sector debt distress, stimulated calls for a more formal and orderly statutory bankruptcy regime, beginning with the Group of Ten's 1996 report *The Resolution of Sovereign Liquidity Crises*. The increasing prospect that some creditors would refuse to participate in informal restructuring agreements drove the specific interest in a treaty-based or statutory cram-down mechanism that would also provide distressed debtors with a payment standstill to sort out their affairs. The IMF responded with its 2001 proposal for an SDRM.

2 Reviews of the costs of sovereign default include Tomz (2007), Sandleris (2008; 2012), Borensztein and Panizza (2009), Tomz and Wright (2013) and Cruces and Trebesch (2013).

3 Rogoff and Zettelmeyer (2002), Jeanne and Zettelmeyer (2004), International Monetary Fund (IMF) (2006; 2012), Diaz-Cassou, Erce-Dominguez and Vázquez-Zamora (2008), Panizza, Sturzenegger and Zettelmeyer (2009), and Das, Papaioannou and Trebesch (2012) provide surveys of the recent history of sovereign debt treatments.

After two years of discussion and revision, the SDRM proposal was eventually rejected in 2003.⁴ Some countries, including the United States and a few large emerging markets, proved uninterested in ceding power to either the IMF or another multilateral body in the manner required for a statutory bankruptcy regime such as the SDRM to function. Some creditors and debtors were skeptical that the IMF or any bankruptcy tribunal could reasonably distinguish between cases of true insolvency and illiquidity; between cases of unable to pay and unwilling to pay; and between cases of bad luck and bad choices, with burden-sharing apportioned appropriately for each of these situations. As a creditor itself, the IMF was also viewed as inherently conflicted in any proposed quasi-judicial role. Finally, there were additional fears that making sovereign debt easier to restructure would render some sovereigns more inclined to move quickly to default in the face of debt distress, to push for too much debt relief too soon in the context of their economic fundamentals. The by-product of even a few sovereigns pursuing “too much, too soon” could be an increase in the borrowing costs for all governments, regardless of their individual histories and debt metrics (Dooley 2000; Rogoff 2003).

In the aftermath of the SDRM’s rejection, focus shifted in 2003 to the more minimalist introduction of CACs in New York-law bonds to contain the power of non-participating creditors to hold up or free ride on voluntary, market-based debt treatments (Helleiner 2008). The introduction of CACs was reasonably smooth: borrowing costs didn’t rise for the issuers of debt bearing CACs, and these new bonds weren’t subordinated to existing debt that lacked such clauses (Eichengreen and Mody 2000; Becker, Richards and Thaicharoen 2003). Indeed, CACs, along with exit consents, had some success in coordinating and bailing-in creditors in some individual country cases (for example, Uruguay in 2003). Given that English-law bonds issued by the same sovereigns had featured CACs for years without suffering subordination or trading at a discount, wariness about the addition of such clauses to debt issued under New York law appears to have been misplaced.

Although some studies find that worries about *ex post*-crisis creditor coordination have been overblown (Trebesch 2008; Bi, Chamon and Zettelmeyer 2011), the 2012 Greece restructuring shows that creditor coordination can still be a meaningful challenge (Schumacher, Trebesch and Enderlein 2012). CAC activation failed in 19 of 36 Greek foreign law bond series that bore such clauses. The clauses required supermajorities of creditors in each individual bond series in order for them to be activated: the Greek CACs lacked aggregation features that would allow creditors to be crammed in on approval by a supermajority of bondholders across all related bond issues. As a result,

it was relatively easy for small groups of investors to acquire, at deep mid-crisis discounts, a sufficient share of any individual bond series to keep the CAC on that bond from being activated. These bondholders subsequently demurred from participation in Greece’s 2012 debt exchange and they were subsequently paid in full.

More generally, Greece’s experience has not been a proof of concept for the current CAC-driven approach to market-based restructuring. Not only did half of the CACs on foreign-law bonds fail, but the other 93 percent of Greece’s debt was issued under domestic law and was restructured only after CACs were retrofitted to it through a unilateral act of the Greek Parliament. It is, therefore, a misnomer to refer to Greece’s 2012 debt operations as a “market-based” restructuring. Additionally, the voluntary nature of the exchange came at a steep cost in terms of the sweeteners used to get the deal accepted (Zettelmeyer, Trebesch and Gulati 2013). Finally, and equally problematic, it is unlikely that the two completed Greek debt treatments were sufficient to make the country’s sovereign debt sustainable: as German Finance Minister Wolfgang Schäuble acknowledged in August 2013 (Steen 2013), Greece will likely need additional support.

In some important respects, Greece’s experience highlights some of the same limits of the market-based approach that were revealed in the earlier sovereign restructurings that have taken place since 2003. In short, market-based restructurings work smoothly so long as creditors receive relatively rich terms (Powell 2011). The 2003 Uruguay and 2005 Dominican Republic reschedulings are often cited as successes of the ad hoc, voluntary approach — and they were successful — but these sovereigns’ challenges were also more limited than is typical of crisis cases. The Dominican Republic only had four bond series that were treated while the structure of Uruguay’s debt stock was also relatively straightforward. Both countries faced liquidity rather than solvency problems; neither required a deep net present value (NPV) haircut; and neither received one: there was little reduction in the NPV of either country’s debt stock. Under these circumstances, it is straightforward for creditors to agree to a voluntary restructuring. Yet, at the conclusion of these reschedulings it still wasn’t clear that either would succeed: the IMF (2006) noted that Uruguay was left with significant vulnerabilities and the Dominican Republic’s post-rescheduling program required substantial additional structural and fiscal reforms to produce sustainability. In the event, both countries benefitted from benign international financial conditions and strong global growth. Since then, non-participating creditors have become far more dogged and creative in pursuing their claims and the scope to impose exit consents, which were particularly useful in Uruguay’s rescheduling, has been narrowed.

Yet, even when market-based restructurings are completed, it is not clear that the results they produce are optimal

⁴ Rogoff and Zettelmeyer (2002) provide a useful discussion of the arguments for and against the SDRM.

(IMF 2013). Market-based approaches underpinned by CACs do not bring stakeholders together *ex ante* to a fully-blown crisis to assess a sovereign's solvency and craft debt treatments that are likely to restore debt sustainability. Instead, CACs, when they work, simply reduce the *ex post* costs of restructuring by easing the process of inter-creditor coordination once the terms of a treatment of distressed debt have been agreed. CACs provide little, if any, nudge to efforts *ex ante* to articulate and agree on these terms.

This wouldn't matter if, as has always been supposed, the dominant problem with sovereign debt is that countries tend to restructure too much of their debt too soon when confronted with difficulties in servicing this debt. If this were true, CACs alone would be an appropriate response. They keep the *ex ante* cost of restructuring high, while reducing the *ex post* cost of completing a debt workout when one becomes unavoidable.

In fact, sovereigns tend to restructure their debt far less readily than theory implies they would. Rather than peremptorily defaulting on their debt obligations, sovereigns tend to defer restructuring unsustainable debt as long as possible — and once they act, the depth of the haircut imposed is often insufficient to restore lasting sustainability. Too much, too soon is not the dominant experience in sovereign debt default. Rather, too little, too late is far more common (Borensztein and Panizza 2009; Levy Yeyati and Panizza 2011; IMF 2013).

The recent focus on reducing the *ex post* costs of restructuring through CACs has left unaddressed three major sources of delay in moving to treat sovereign crises (Buchheit 2011). First, sovereign governments are generally reluctant to recognize the severity of a crisis, hoping that circumstances will change and the difficulties they face will abate. Second, creditors are also keen to defer entering discussions with a debtor sovereign in the hope that multilateral and bilateral support to the sovereign will allow creditors to be paid in full and eliminate any payment difficulties occasioned in a crisis. Third, other sovereigns may wish to see efforts to address a crisis forestalled out of fears that such efforts could cause contagion and materially worsen their own circumstances.

Over recent decades, the costs imposed by these impediments and delays have risen. Cross-border capital flows have expanded exponentially, the variety of sources of sovereign finance has widened and an increasing share of sovereign borrowing is financed through bond issuance rather than through bank credit. The scale of sovereign obligations that have to be treated in crises has grown and, concurrently, so too have the costs of delays in taking action to restore sovereign solvency when it is under threat (Borensztein and Panizza 2009; Powell 2011; Powell, Sandleris and Tavella 2013).

With ever-higher stakes, but little improvement in our systems to deal with them, sovereigns are left with few options but to conclude relatively creditor-friendly debt workouts that may not be sufficient to produce long-term sustainability — the too *little* that accompanies too late in the recent history of sovereign debt restructuring. Sturzenegger and Zettelmeyer (2007) find that the post-crisis yields for countries that restructured between 1998 and 2003 imply that creditors bore lighter losses than the headline numbers projected at the time of these restructurings. An exercise on the remaining sovereign debt treatments completed after 2003 produces similar results.

It should be underscored that when sovereigns seek debt treatments that are too little and too late, private creditors may have widely divergent interests in the pace and extent to which a sovereign's debt problems are addressed. As has been in the case in corporate restructurings, long-term or hold-to-maturity "real money" investors such as banks, pension funds, insurance companies and endowments have generally demonstrated constructive willingness to be proactively involved in resolving sovereigns' debt problems. In the 2012 Greek restructuring, the Institute of International Finance (IIF) notes that it was able to organize its members to engage in negotiations and reach a consensus view within six weeks. Among speculative investors, interests have typically been much more varied. Some speculative investors have tended to engage early and constructively in seeking durable solutions for sovereigns in financial trouble, while others have clearly benefitted from decisions to take deeply discounted positions in distressed debt, resist attempts to activate CACs, and hold out for full payment on their holdings.

If a first effort at producing sustainability is unsuccessful, subsequent attempts may be even more challenging. After two rounds of debt treatments and support from the troika of the IMF, European Commission and European Central Bank, more than 70 percent of Greece's public debt is now owed to official creditors. Similarly, a number of small island states in the Caribbean and Pacific have recently been through serial restructurings and now see their debt stocks dominated by obligations to senior creditors. In principle, this debt can't be rescheduled or restructured adequately under existing conventional terms to put these countries on a sustainable footing. Although neither Greece nor these small island states are *prima facie* systemically critical, Greece provides ample demonstration that even a small country's problems can create global problems and, in so doing, rewrite the rules by which we deal with sovereign distress. Both Greece and the heavily indebted small island states imply that our current approaches to sovereign debt restructuring will have to be revised imminently.

In practice, there likely is no single monolithic solution that can be practicably implemented to produce optimal

sovereign debt treatments in times of distress. Efforts need to be balanced to address both *ex ante* and *ex post* costs of sovereign debt restructuring so that the end result is neither too much, too soon nor too little, too late, but rather debt treatments that are just right, just in time. In theory, a perfectly designed statutory mechanism that is implemented under ideal conditions ought to be able to achieve such a balance. In practice, such perfection is difficult to achieve and there is, in fact, little political will to try. In theory, contracts could be perfectly designed to balance debtor and creditor interests (Grossman and Van Huyck 1988). In practice, ideal implementation of such contracts would require a capacity to accurately distinguish cases of illiquidity from those of insolvency, and it would require contractual terms that could not be subverted by creative creditor litigation. In fact, the last 10 years are ample proof that neither of these conditions tend to prevail.

The 2008 financial crisis and its aftermath rekindled interest in improving approaches to handling sovereign debt distress in order to get closer to results that are just right, just in time. This renewed willingness to work toward solutions is driven, at least in part, by the development that industrialized countries are now as vulnerable to debt distress as emerging markets. Moreover, the costs for developed markets may be higher than for emerging countries: financial markets have generally allowed industrialized countries to borrow much more than emerging markets; and developed market debt ratios are substantially higher than those of their emerging counterparts (Reinhart, Rogoff and Savastano 2003; Dell’Erba, Hausmann and Panizza 2013; IMF 2013).

A range of reform proposals have been advanced, but none of these ideas will single-handedly provide optimal crisis resolutions. Following their meeting in Deauville in December 2010, German Chancellor Angela Merkel and former French President Nicolas Sarkozy indicated a keen willingness to go as far as the creation of a European SDRM. They echoed elements of plans advanced by Gianviti et al. (2010), the European Economic Advisory Group (EEAG) (2011), Bogdandy and Goldmann (2012), and Miller and Thomas (2013). In the end, they settled on the introduction of a standard European two-step CAC for all sovereign debt issuance in the euro zone from 2013 onward. Other proposals have focussed on mutualizing certain portions of sovereign debt issuance, refining CACs, widening the issuance of state-contingent debt, immunizing debt restructurings from non-participating creditors and making debt restructurings more automatic. An ideal framework for resolving sovereign distress would smooth *ex ante*, *in medias res* and *ex post* impediments to reaching and implementing agreements that balance debtor and creditor interests, but few elements of these proposals meaningfully take on the need to address *ex ante* impediments to treating sovereign debt.

TAKING ACTION TO REDUCE THE EX ANTE COSTS OF TREATING SOVEREIGN CRISES

In an effort to address the *ex ante* costs that inhibit the proactive treatment of sovereign crises, this paper revisits Richard Gitlin’s earlier proposal (Gitlin 2002) for an SDF, expands on this concept and updates it in light of the recent developments outlined above. The SDF would have two major features that are explained in detail in the remainder of this paper.

First, it would provide a centre for continuous improvement of the processes for dealing with financially distressed sovereigns. At present, there is little continuity in the periodic efforts to refine the resolution process for distressed sovereigns. By providing a standing body for scholarship, discussion and policy analysis, the SDF would prevent the development of another fallow period in this area, such as the one that prevailed from 2003 to 2008. The SDF would help ensure that efforts to improve sovereign workouts are less sporadic and more consistent, benefit more profoundly from previous episodes of distress and derive deeper lessons from earlier attempts at reform.

Second, the SDF would furnish an ongoing venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises when they arise. By reducing the impediments to *ex ante* dialogue between country authorities and creditors, the SDF would be expected to assist them in coming to terms with a sovereign’s financing stress at an early stage when the range of options available to them is widest, the chances of avoiding a restructuring are greatest and disruptions to national and international financial systems can be minimized.

This paper lays out a pragmatic blueprint for the creation of an SDF. It also outlines a realistic agenda by which the SDF could be complemented by a small set of additional incremental reforms. The paper is structured as follows: following this introduction, the paper identifies lessons from other efforts at international cooperation through non-statutory means; it describes a possible structure for an SDF; it explains how the SDF would complement and contrast with other reform proposals; and it concludes by outlining a broad framework for implementing the SDF.

LESSONS LEARNED: INCREMENTAL REFORM CAN WORK

The rejection of the SDRM left the world with a skewed sense that reform of the processes for dealing with sovereign debt distress is nearly impossible: it is not. While widespread official support for another big bang proposal such as an SDRM is unlikely any time soon, incremental initiatives

at the national and international levels in other realms demonstrate two practical insights. First, in areas where policy reform is particularly difficult, an independent, non-governmental body dedicated to finding incremental ways to improve on the status quo can provide substantial and transformational support to the intermittent efforts of public institutions to respond to and drive change. Second, non-statutory fora can facilitate intergovernmental policy advances even when treaty-based approaches are difficult or even impossible to conclude. Some lessons from experiences in corporate insolvency, bilateral sovereign debt restructuring, anticorruption efforts in extractive industries and trade policy liberalization that highlight both the potential utility and the feasibility of an SDF are considered below.

LESSONS FROM CORPORATE INSOLVENCY

There is much to learn from recent efforts at the national and international levels to improve the ways in which corporate insolvency is handled (Bolton 2013). In the United States, the American Bankruptcy Institute (ABI) has worked since 1982 to evaluate US insolvency law and, at the request of Congressional and other legislative staff, to analyze proposed bills in order to optimize improvements to the US bankruptcy system. With over 13,000 members, the ABI provides ample proof of the demand for a dedicated institutional repository of detailed knowledge on best practices in dealing with corporate financial distress. At the global level, the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) brings together 44 national member associations, including the ABI, to exchange information and ideas on best practice on corporate turnarounds and insolvency, while also working to assist in the development of cross-border insolvency policies, international codes and consensus on best practice.

The work of the ABI and INSOL implies a few key lessons in the efforts to improve the terrain of sovereign crisis workouts. First, the successful launch of both organizations shows that a small group of dedicated individuals would be able to found and initiate the work of an SDF. Both institutions proved their usefulness through action rather than through abstract forecasts on how they would add value to corporate insolvency solutions.

Second, these organizations demonstrate the benefits of having an entity focussed solely on improving the process by which sovereigns in financial distress are handled. The economic and legal issues around sovereign debt are complicated: innovation to address these issues requires dedicated analysis, sustained attention, a focal point for collective work and an institutional repository for lessons learned that builds on past experience. At present, none of these things exist. The world focusses only periodically on

sovereign debt, usually when there is a cluster of payment problems. In the wake of the SDRM's rejection in 2003, the IMF went virtually silent on this issue until it released a policy paper in April 2013. As a result of such silences, it is necessary to start nearly from scratch each time there is a crisis; the world tends to fragment into multiple fora with overlapping work streams, relearn old lessons and rediscover old insights. Efforts to improve the process of sovereign debt treatment advance only haltingly as a result. The world instead needs a dedicated team that will sustain efforts to learn from the past, build institutional memory and apply these lessons on an ongoing basis to make sovereign debt more resilient and the workout processes around it more effective.

Third, policy makers profit from having a private, non-public source of counsel on how they can improve debt restructuring and re-profiling processes. Owing to the lingering fear of too much, too soon, sovereign debt treatment will always be a politically fraught issue. Assessments of creditor-debtor equity, the capacity of a debtor to pay versus the extent to which it can adjust, and possible enforcement mechanisms will involve shifting proportions of dispassionate cost-benefit analysis, judgment and, to some degree, hope. Public servants are likely to generate better policy and make better decisions if they can discreetly test their proposals with a learned, detached body that doesn't have a vested interest in a particular solution.

Fourth, when a debtor finds itself in distress, its authorities may also benefit from informal access to an adviser that can even-handedly marshal the body of precedent, reflect on how it applies to a particular country's circumstances and point out where new paths might be broken. At both the corporate and the sovereign level, it is either impossible to seek informal advice from judicial bodies or, at the sovereign level, seeking advice from the IMF or other multilaterals is highly stigmatized and coloured by the recognition that the counsellor is also a creditor. A single-purpose, private membership-supported advisory organization sidesteps these problems.

Fifth, both the ABI and INSOL provide a common forum in which all stakeholders can engage and create intimacy and trust among themselves. As private institutions, neither the ABI nor INSOL is bound to limit its membership; instead, both are intentional bodies whose membership can be open to interested parties. When stakeholders know and trust each other, they can negotiate better solutions. The existence of an open, common forum in which they can interact makes this possible.

Sixth, the ABI and INSOL demonstrate that private organizations can complement and enhance the work of public bodies and processes with important functionalities that are effectively impossible to negotiate through treaty-based or statutory processes. Such "shadow" institutions

can act flexibly and effectively, without requiring any of their stakeholders to compromise their respective powers or leverage. Their scope can also be adjusted to ensure continual consistency with any new efforts to enhance public institutions and formal processes.

LESSONS FROM OTHER INTERSTATE INITIATIVES

There is a variety of interstate initiatives that lack treaty-based underpinnings, but that have, nevertheless, been able to deal with increasingly complex international problems in experimental and innovative ways across a variety of spheres. Consideration of sovereign debt problems naturally seems to lean toward solutions that involve formal negotiated agreements between sovereign states. This unnecessarily limits options. This inclination is not, however, a case of allowing the perfect to be the enemy of the good: perfection doesn't necessarily rest in symmetric intergovernmental treaties and structured multilateral institutions. Progress usually requires experimentation, and at the national and subnational levels, governments often find that private, not-for-profit actors can develop and test models in ways that ultimately inform policy, but cannot be pursued within public bodies. From charter schools to private-public partnerships in infrastructure development to hybridized models of health-care delivery, public advances are sometimes achieved through private pathways. The same holds true at the international level, although it may be less obvious, and certainly less celebrated.

The features of five bodies that offer some insights on the practicalities of creating an SDF are considered below. This review is not intended as an endorsement of these bodies or their particular achievements; instead, it is intended as a demonstration that some of the informal aspects of the SDF proposal outlined below already have successful precedents.

THE NON-INSTITUTIONS: THE PARIS AND LONDON CLUBS

The Paris and London Clubs are the closest corollaries to a possible SDF and, therefore, merit the sharpest attention in this comparative discussion.

The Paris Club demonstrates that even in the absence of a formal multilateral treaty or agreed multinational institution, sovereign bilateral creditors can come together and agree on concerted action to address both individual country financing crises and endemic debt problems, such as low-income-country chronic indebtedness, which cut across wide swathes of circumstance. Over decades, despite being a standing “non-institution” housed and staffed by the French Ministry of Economy and Finance at Bercy, the Paris Club has built up a precedent-based set of norms and informal rules for sovereign debt treatments

that are well codified despite not being legally constituted. The Paris Club's collective, consensus-based decisions are recorded in “agreed minutes” that have no legal status; their terms are implemented through bilateral agreements between debtor sovereigns and their individual creditors. Without any formal status, the Paris Club has, over 50 years and more than 400 debt treatments, become an essential part of almost all sovereign crisis workouts, in large part because of the intimacy and trust it creates among bilateral creditors through its regular schedule of meetings.

The Paris Club functions well for its limited remit and its constituency of industrialized country bilateral creditors. Although it is expanding its outreach to new emerging bilateral creditors and it is working to make its processes more equitable to debtors, the Paris Club is seen in some polities as a representative body for industrialized country creditor interests. Emerging countries may be reluctant to join the Paris Club as they see it as an instrument for Organisation of Economic Co-operation and Development (OECD) member-country agendas. Private creditors may see it as somewhat beholden to sovereign interests, not least because it is housed in a government ministry. As a result, it is unlikely — but not impossible — that a simple expansion of the Paris Club's membership, widening the scope of its processes and deepening its secretarial bench, could fulfill the mandate and functionality envisioned for the SDF as a fully inclusive, research-based, proactive facilitator of improved sovereign debt treatments.

The London Club is a much more ephemeral and ad hoc non-institution: it is a loose collection of London-based banks that comes together on a case-specific basis to discuss situations of sovereign distress. As such, it is less instructive for the creation of an SDF: at any given time it is not clear that the London Club exists or who one would call to activate it; it has no standing features, processes or precedents; its membership is limited to banks and it has at times appeared to resist the involvement of bondholders; and it has no continuous research functionality or meetings. The London Club is really a tradition of *ex post* creditor coordination, a sort of diffuse baseline intentionality to form a creditor committee if or when necessary. It may even be the case that the notion of the London Club has been superseded with the IIF's recent involvement as a coordinator of private creditors in the treatment of Greece's debt. An SDF would build on the Paris Club, London Club and IIF processes, involve them as key constituents, and extend their work further.

THE NON-PROFIT: EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE

The Extractive Industries Transparency Initiative (EITI) offers a model of the possible evolutionary development of an SDF. The EITI grew out of the “Publish What You Pay” (PWYP) campaign that, from 1999 onward, has encouraged extractive firms in the oil and mining sectors

to make public their payments to the governments of the countries in which they operate. An initial effort to comply by BP plc proved unworkable: it quickly became clear that corporations would be disadvantaged by unilateral PWYP compliance.

The project consequently evolved from 2002 onward into the EITI under the support of the United Kingdom's Department for International Development (DFID). Over a number of years, the EITI shifted its focus from individual companies publishing their payments as part of their commitment to corporate social responsibility to governments undertaking to disclose transparently all payments they receive from extractive companies operating under their jurisdiction. During the period of DFID's sponsorship, a core statement of EITI principles was articulated in 2003 and a framework for reporting was developed in 2004 through a series of meetings. Over 40 institutional investors indicated their support for EITI at the outset, a number of emerging and frontier resource-producing countries expressed their interest in exploring how the EITI principles could be practically applied and the concept was championed at Group of Eight (G8) summits during 2003 and 2004. The G8 subsequently called on the IMF and the World Bank to provide technical support to governments wishing to adopt transparency policies. This led to the establishment of the World Bank-administered Multi-Donor Trust Fund (MDTF) for the EITI in 2004. The MDTF has disbursed almost US\$60 million in technical and financial assistance to EITI programs in 37 countries.

The EITI shows that talk can be transformed into meaningful action supported by financing within only a few years. By the time of the third EITI global conference in Oslo, Norway in October 2006, the implementing countries were preparing their first EITI reconciliation reports and the EITI's International Advisory Group, made up of corporate, sovereign and civil society representatives, had sufficient emerging consensus to introduce the EITI Validation Guide, which set out the indicators that implementing countries had to meet in order to become EITI compliant. The guide also included for the first time a formal process to sign up to become an EITI "Candidate Country."

As the EITI became institutionalized, incorporation as a non-profit entity was a useful next step. From 2002 to 2006, the EITI had been valiantly run by a small team in the United Kingdom's DFID. Incorporation implied that the EITI needed to have its own governance structure: a board, a secretariat and a members' conference every two years to appoint the board. EITI was formally incorporated as a non-profit organization in Norway.

The EITI provides a clear example of how a governmentally supported non-profit membership organization can facilitate sovereign engagement with industry and civil society around the development and refinement of a

common set of principles and a core set of best practices to implement them. It demonstrates that sovereigns, private sector companies and non-governmental organizations can create and operate effectively within a single governance structure. The EITI also shows that a "big bang" approach, where the entire collection of the world's 190-odd countries sign up for a common treaty, is not necessary to advance global reform: countries sign up to the EITI principles as they deem them to be relevant to their particular circumstances, and as the countries themselves are ready and capable of compliance. Similarly, countries donate to the EITI MDTF voluntarily. Finally, the EITI shows the power of a single national champion in advancing international-level reform. Without the doughty work of a small team of UK government officials, the EITI might never have got off the ground.

THE UNCODIFIED: ASIA-PACIFIC ECONOMIC COOPERATION

Asia-Pacific Economic Cooperation (APEC) is as well known for the colourful shirts participating heads of government wear at its annual summits as it is for its substantial achievements: both arise out of an uncodified tradition of concerted action. Created in 1989, APEC is an intergovernmental grouping that operates on the basis of non-binding commitments, open dialogue and equal respect for the views of all participants. Unlike the World Trade Organization (WTO) or other multilateral trade bodies, APEC requires no treaty obligations of its participants. Decisions made within APEC are reached by consensus and commitments are undertaken on a voluntary basis. APEC has 21 "member economies,"⁵ which account for approximately 40 percent of the world's population, approximately 55 percent of world GDP and about 44 percent of world trade.⁶ Since its inception, APEC has worked to reduce tariffs and other trade barriers across the Asia-Pacific region. The "Bogor Goals" of free and open trade and investment in the Asia-Pacific for industrialized economies by 2010 and by 2020 for developing economies are key to the realization of APEC's vision. These goals were adopted by leaders at their 1994 meeting in Bogor, Indonesia.

APEC has led to real progress. When APEC was established in 1989, average trade barriers in the region stood at 16.9 percent; by 2010, barriers had been reduced to 5.8 percent. As a consequence, intra-APEC merchandise trade (both exports and imports) grew from US\$1.7 trillion in 1989 to US\$9.9 trillion in 2010, nearly a six-fold increase, which now accounts for 67 percent of APEC's total merchandise trade. Similarly, APEC's

5 See www.apec.org/About-Us/About-APEC/Achievements-and-Benefits.aspx.

6 See www.apec.org/About-Us/About-APEC/Achievements-and-Benefits.aspx.

total trade (both goods and services) increased from US\$3.1 trillion in 1989 to US\$16.8 trillion in 2010, over a five-fold increase. In the same period, total trade by the rest of the world went from US\$4.6 trillion to US\$21.1 trillion (a multiple of 4.6 times). By June 2011, 48 free trade agreements had been signed between APEC members; there are currently 42 free trade agreements in force between APEC economies.⁷

APEC is elastic enough to accommodate a wide agenda of possible concerted action. It is also investigating the prospects of, and options for, a Free Trade Area of the Asia-Pacific. It has developed 15 model measures for regional and bilateral free trade agreements that serve as a reference for APEC members to achieve comprehensive and high-quality agreements. APEC has additionally acted as a catalyst in the advancement of WTO multilateral trade negotiations, intraregional business facilitation, coordinated security arrangements and technical cooperation.

APEC is a testament to the power of concerted action: peer pressure can sometimes drive as much progress as formal agreements and, most importantly, peer pressure can ensure progress when formal, symmetric agreements are difficult. APEC also shows how broad support for a general set of principles gives political cover and policy structure for countries to move unilaterally on reforms, without insisting that others move in lockstep with them. Finally, APEC shows that all of this can be facilitated with a relatively small and nimble secretariat: the Margaret Mead dictum that a small group of people can change the world gets instantiated every year by the APEC secretariat in Singapore.

THE PROCESS IN SEARCH OF AN INSTITUTION: THE GENERAL AGREEMENT ON TARIFFS AND TRADE

The General Agreement on Tariffs and Trade (GATT) process shows that progress on reform can be achieved even when the institution meant to facilitate it doesn't exist. The history of the GATT is long and circuitous, and given that it is well known, it does not need to be recounted in detail here. It is mentioned simply as a reminder that it isn't necessary to implement every element of an ideal SDF structure at the same time in order for the SDF to operate and create a positive impact on the sovereign debt restructuring process. Negotiations under some five decades of the GATT process achieved meaningful reductions in trade barriers, even as agreement on the creation of the WTO remained incomplete. Similarly, the SDF's functionalities could come into being in a sequential fashion: it might first build up credibility as a standing research body, and then,

with this demonstrated expertise, it may be called upon by sovereigns in distress to help facilitate their discussions with creditors and other stakeholders. A new Rome need not be built in a single day.

PROPOSAL FOR AN SDF

The SDF proposal envisages a new organizational structure that would provide a welfare-maximizing approach to addressing both too little, too late and too much, too soon, while mitigating the trade-off between them.

SDF DESIGN: THE BIG PICTURE — VISION, MISSION, VALUES, VALUE ADDED

OVERVIEW

In view of recent unsuccessful statutory attempts to enhance the system of resolving sovereign debt crises, the SDF would be a non-statutory, independent standing body incorporated as a non-profit with a broadly based and inclusive membership of stakeholders that are relevant to sovereign crisis resolution. The SDF would provide a central venue for continual analysis and discussion on key ways to improve the processes by which sovereigns in financial distress are treated. The SDF would identify and develop best practices based on a continually updated and rigorously maintained repository of data. The SDF would also provide a low-stakes, ongoing forum in which debtors, creditors and other stakeholders could continually review and anticipate sovereign vulnerabilities and distress, and initiate focussed discussions on particular sovereign cases.

MISSION

To provide an independent standing body that will bring creditors and debtors together in a centre of evolutionary best practice in order to address sovereign financial stress at an early stage and maximize residual value for both sovereign debtors and creditors.

VISION

Within five years, the SDF would be a recognized centre of excellence in research on sovereign debt workouts and could point to substantive and specific ways in which it has provided meaningful contributions to global efforts to lower the *ex ante* costs of debt treatment sufficiently to diminish the tendency toward sovereigns achieving too little, too late in treating their problematic or impaired debt burdens.

CORE VALUES AND PRINCIPLES

The SDF and its staff will be noted for their: impartiality; independence; focussed efforts to achieve neutrality; a singular commitment to transparency; equity in operations

⁷ See www.apec.org/About-Us/About-APEC/Achievements-and-Benefits.aspx.

and in the burden sharing of the costs engendered in debt treatments; a presumption toward proactive action; a respect for precedent; a creative impulse to innovate; a predisposition toward collaboration; and respect for the preservation of core values, rights and responsibilities. The SDF would be structured and would operate in a manner broadly consistent with the IIF's Principles for Stable Capital Flows and Fair Debt Restructuring (Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution 2012), the UN Conference on Trade and Development's Principles on Responsible Sovereign Lending and Borrowing, the UN Commission on International Trade Law's core articles, and the IMF's lending into arrears policies, while also aiming for consistency with relevant aspects of INSOL's founding statements. Moreover, the SDF would provide a venue in which these principles would be brought to life and applied.

The SDF would dampen the tendency of sovereigns to delay dealing with their debt problems in three key ways. First, the SDF would provide the world's only international body solely focussed on sovereign debt and the identification of best practice in the resolution of financial crises. This focus would ensure that the SDF could act as an institutional repository of knowledge on sovereign debt distress, provide a centre for learning and compile lessons from past sovereign debt treatments to continually refine existing approaches to sovereign debt treatment. This would help make sovereigns' and creditors' processes more predictable, credible and more likely to succeed, thereby increasing the incentive to deal with debt problems expeditiously.

Second, it would blunt the "trigger problem," which makes countries reluctant to address incipient crises out of a fear that doing so will set off a self-fulfilling chain of events. Because of this fear, financially strained countries tend to delay approaching both the IMF and their creditors at an early stage. The SDF would provide a non-statutory, independent, standing forum in which sovereign financing prospects and debt sustainability would be continually reviewed in a dialogue between debtors and representatives of the creditor community such that there would not be a trigger point per se: there would be no clear start of talks, no infamous walk of shame by the finance minister to 700 19th Street NW, Washington, DC, and no front-page spread of the IMF mission arriving at the central bank's front doors.

Third, by creating the conditions and incentives to treat sovereign debt problems proactively, the SDF would improve the odds that genuine liquidity crises can be contained before morphing into all-out solvency crises. Replacing today's ad hoc approach to sovereign debt treatment with a predictable, optimized process would help to ensure that just right, just in time comes to dominate too little, too late.

The SDF would not replace or compete with existing institutions. Instead, it would bring together sovereign interests, IMF surveillance, regional institutions' analysis, sellside research, buy-side concerns and civil society engagement in an informal standing forum that would allow these varied interests to be enumerated, reviewed and, where possible, reconciled with the assistance of SDF staff on an ongoing basis. In so doing, it would move forward significantly the process of stakeholder engagement in our approaches to dealing with sovereign distress.

SDF DESIGN: THE DETAILED PICTURE — OPERATIONAL MODEL

FOUNDING

The time is now. The SDF could be founded and incorporated by a small group of individuals and would require minimal support to initiate its work.

Fair, balanced and comprehensive representation. Membership should be reasonably open and should include relevant constituents in the sovereign debt and policy community: sovereigns, representatives of major creditor classes, legal bodies, academics and others. The set of representatives party to an SDF process could be fluid depending on circumstances, the debtor under consideration and the particular challenges it faces. The creation of standing-member advisory groups would be encouraged during non-crisis periods to ensure constituents' interests can be represented quickly, fairly and clearly during times of sovereign distress without overburdening the SDF's processes.

A limited remit. With many actors already in the international system, any new addition should be designed to ensure that its mandate does not overlap with existing institutions. Instead, it should be a convener and provide a venue for existing actors to meet and discuss, informed by the SDF's ongoing research functions. This mandate is, as some have noted, "embarrassingly simple." This is by intent: such comprehensive conversations, informed by shared data, do not currently happen on a proactive basis.

Subsidiarity. No aspect of the SDF's work would be intended to replace, challenge or supersede the work of existing processes or institutions. For instance, SDF staff would not be charged with developing alternatives to members' analyses; instead, they would be tasked with transparently compiling research on best practices and, in facilitating discussions for specific sovereigns, they would be expected to reconcile competing data and analyses from the SDF's members in the discovery and negotiation process in order to help build balanced views on needed macro adjustments and the possible treatment of any relevant debt. Most notably, this would enhance the credibility and ownership of the IMF-supported debt

sustainability analysis (DSA) and adjustment program among all stakeholders.

Non-statutory and not formally codified. The SDF would not be a multilateral institution: it would not be created by statutory agreement, but rather by informal consensus among a subset of stakeholders or committed individuals. This approach reflects the observation that there appears to be little appetite in the current environment for the pursuit of a statutory-, convention- or treaty-based approach to handling sovereign crises. It would instead be constituted as a non-profit entity that would engage in research and building codified, but not necessarily legal, precedent in its operational work.

Incorporation as a non-profit entity. Incorporation is the most fundamental way to bring the SDF into being. As the EITI demonstrates, a committed sovereign or group of creditors could decide to incorporate an SDF as a non-profit entity in a supportive country or in a location that broadly satisfies the following criteria: proximity to a major financial centre; an advantageous incorporation framework; an efficient tax and fundraising environment; and close connection to major international public sector financial institutions. Initial incorporation could also be pursued without explicit sovereign support in a preliminary effort to establish the SDF and provide proof of its utility.

Some natural candidate sites for the establishment of the SDF could include:

- **United States:** The SDF could be incorporated under the jurisdiction of a state where terms are favourable (for example, Delaware, District of Columbia), but constitute business in New York City for easy access to financial markets and the New York Fed. Alternatively, the SDF could constitute its business in Washington, DC to be close to the international financial institutions, the US Treasury and US regulators. New York's attractiveness at present may be diminished by the *NML v. Argentina* ruling and could remain impaired until a remedy is provided that immunizes payment systems that pass through New York.
- **London:** Like New York, London represents a prioritization of proximity to a financial centre while adding the long-standing institutionalization of CACs under English law and germane tax treatment of non-domiciled staff. Location of the SDF in London could help drive British action to immunize their payment systems against attempts by non-participating creditors to attach themselves to debt service payments on restructured debt.
- **Belgium:** Belgium offers an incorporation structure as an *Association internationale sans but lucratif* (AISBL)

or international non-profit organization that is particularly advantageous for an institution such as the SDF. Brussels also offers a location close to European institutions, central transportation links, a low cost of living and proximity to major financial markets. Additionally, the Euroclear payments system has already been immunized from the threat of holdout creditor attachment.

- **Scotland:** Scotland's regional government has published a white paper on independence in which chapter 6 indicates Scotland's interest in establishing Edinburgh as a centre for sovereign debt mediation (Government of Scotland 2013). While this might provide a supportive and attractive environment for the SDF, the 2014 referendum on independence and doubt regarding legal frameworks could put the setting for an SDF located in Edinburgh in flux for several years to come.
- **Switzerland:** Switzerland has also expressed an interest in becoming a centre for sovereign debt treatment and crisis resolution in recent government statements. As global money centres, both Zurich and Geneva could provide useful homes for the SDF, but both are relatively high-cost locations.
- **Emerging-market financial centres such as Dubai, Hong Kong or Singapore:** Any of these three locations would provide proximity to an international financial centre and new official creditors. All three are also straightforward jurisdictions in which to incorporate.

Independent venue. To preserve the SDF's neutrality while allowing it to be built quickly and practically, the SDF might be housed in a multilateral institution that is not itself a creditor and is located in a major financial centre, such that meetings would be relatively easy for members to attend. For instance, the Bank for International Settlements, which was originally charged with overseeing the resolution of international debt problems arising from German war reparations, could be a host institution for the SDF. Alternatively, as is the case with the Paris Club, the SDF could be housed in the capital of a country willing to position the SDF at one of its governmental institutions, but this may be seen to unacceptably condition the SDF's impartiality. The substance and perception of independence should trump expediency in the establishment of the SDF.

The SDF is incentive compatible for its likely participants. Incentives for participation in an SDF stem directly from the benefits all classes of creditors and the distressed sovereign are likely to derive from its operations. Both creditors and debtors would gain from the creation of an SDF. Policy makers need greater reassurance up front that crisis resolution can be undertaken in an orderly fashion that minimizes collateral damage and delays. At the same time, investors need greater clarity on the norms,

precedents and processes that will guide sovereign crisis resolution so that they can reasonably assess and price risk. An SDF could preserve an institutional memory of past sovereign treatments and, on the basis of the insights these experiences provide, facilitate faster and smoother future sovereign crisis resolution by maintaining an organized and impartial venue for information discovery and negotiation.

Staffing. The SDF would require a small, full-time staff of legal, financial and economic experts. It should be lean and minimalist in its construction with a CEO, deputy and expert advisers. The SDF staff could be supplied through secondments from SDF members or *de novo* hires, while the CEO would need to have sufficient international stature to secure participation in the initial operation of the SDF and maintain its relevance. The staff would be expected to act independently and impartially, with full detachment from any sponsoring institutions.

Financing. The SDF would need secure, multi-year financing in order to preserve its neutral standing. There are a number of options for funding the SDF's operations, including, *inter alia*: multi-year contributions from members to a trust fund; contributions toward an initial endowment that would generate sustained annual income; annual tax-advantaged fundraising efforts; and membership fees.

CENTRE OF EXCELLENCE IN RESEARCH

Institutional memory on maintaining best practice and developing new approaches. Today, there is neither continuity nor centrality in research on sovereign distress and work on its application. There is, instead, occasional focus on the resolution process for a distressed sovereign through multiple work streams and many discussion venues, focus that is generated only periodically by crises. The SDF secretariat would provide a focal point for this work, ensure it is sustained and made coherent, and builds on insight from each episode of sovereign distress. Smooth sovereign debt restructuring is too critical to the international financial system to leave it to ad hoc work programs that come in and out of prominence within existing institutions and relevant organizations.

Enhanced and transparent data provision. The SDF staff would assist in the rapid exchange of economic and liability information among relevant parties following agreed protocols. SDF members could consider the creation of a standing debt registry to speed the identification of relevant interests in future debt discussions, though this function may be sufficiently fulfilled by the Financial Stability Board's (FSB's) Legal Entity Identifier initiative. The SDF's operations would be dedicated to greater information sharing.

FACILITATED DISCUSSION

Broad participation in crisis resolution. Unless otherwise agreed, all relevant stakeholders should be included in any research effort, crisis resolution process or debt treatment. Each creditor group's position with respect to the sovereign should be treated equitably and coherently.

Coordination with existing representative and negotiating bodies. The SDF would consult closely with existing representative and negotiating bodies, such as the Paris Club; other creditor committees or representative bodies, such as the IIF, the FSB and the OECD's Development Assistance Committee; and the international financial institutions. Coordination with the IMF's work on the DSA and any adjustment program would be central to the SDF's work. The SDF would facilitate exchanges between stakeholders of data and analyses on the sovereign debtor to fine-tune remedies under consideration for the sovereign's distressed state.

Facilitation of early, proactive discussion in an intimate setting that builds credibility and trust. Past sovereign crises demonstrate the need to convene stakeholders at an early stage in an intimate setting with substantial information sharing in order to move quickly and efficiently toward effective crisis remedies. Any new international body or venue should assist in making this happen. This intimacy among bilateral creditor representatives is a key feature of the Paris Club's operations.

Continual discussions ensure that the "trigger" problem is minimized. There would not be a point where discussion of a country case begins: it would be subject to continued review of emerging vulnerabilities and the shift to specific focus on a particular country case would be intentionally seamless.

Content of discussions. Initial SDF discussions would focus on the design of the sovereign's macro program, the sustainability of its debt and its capacity to pay, all building on work by the IMF in conjunction with the sovereign, contrasted against and reconciled with analyses prepared by creditors and other stakeholders. Discussions could eventually move to consideration of the terms of a possible debt treatment — or the measures needed to avoid a treatment — always keeping in mind the need to support the sovereign's capacity to grow out of its crisis, and maintaining the presumption that creditors should be made whole whenever possible. Initiation of discussions under an SDF would not presuppose automatic movement to a debt treatment: in fact, it is hoped that early discussion would forestall and prevent a restructuring.

Equal and concurrent information sharing. Information would be shared among SDF members on an equal and concurrent basis. SDF members would be expected to participate in the forum's proceedings with an enhanced

level of inter-member transparency in the discussion of public data. This would ensure support for and credibility in discussions of the debtor's macroeconomic program, the adjustments the sovereign proposes to undertake, assessments of the sovereign's capacity to pay, burden sharing among creditors and the terms of any possible debt treatment, should one prove necessary.

Comparability of treatment and fair burden sharing. SDF members would commit to processes that would ensure, to the greatest extent possible, comparability in the treatment of claims, limits on free riding and follow-through on fair burden sharing. Advisory or representative groupings would be encouraged to review general procedures, specific negotiations and debt treatments to ensure that these principles are maintained.

Agreements reached under the auspices of the SDF would not be legally enforceable. Mindful of the Paris Club's operational example, the SDF's work could be based on a number of concerted, yet informal guidelines and principles to be outlined by its constituents and developed over time through individual case work and precedent. Such touchstones would facilitate open and informed decision making and a more rapid conclusion of consensus on the appropriate responses to future episodes of sovereign distress. The SDF would not, however, constitute a formal arbitration process.

Predictability. SDF members should aim to design a collective, consistent process that would provide a flexible template for the discussion of sovereign crises. This template would remove the guesswork that currently exists in initiating an open dialogue on a particular sovereign crisis, but, as a non-statutory tool, it would be applied flexibly on a case-by-case basis. Cut-off dates on treatable debt may be considered to ensure that financing can continue to be provided to the debtor sovereign during discussions.

Building on, but not bound by, precedent. The SDF's informal nature would allow it to evolve rapidly and adjust to circumstance, while its professional staff would continue to inform SDF members of the lessons and insights of past experience. As a non-institution, the SDF's deliberations and eventual understandings would be recorded in minutes that would outline agreed actions and information. As in Paris Club processes, these agreed minutes would have no legal standing and, hence, would not represent binding precedents.

Sequencing. Most importantly, the SDF should hasten consultation on a sovereign's solvency among relevant stakeholders in an independent setting. It should reverse the usual sequence of crisis management when sovereign solvency is questionable. Instead of initial public lending into an adjustment program followed by a possible debt treatment to create sustainability, use of the SDF

framework should prompt proactive engagement with creditors, earlier determinations on solvency, incite faster movement to treat debt should it appear necessary and stimulate subsequent lending to foster growth in the context of a sustainable debt stock.

Greater speed in execution. By maintaining a standing body between episodes of sovereign distress, the SDF would enable the international system to respond to debtor and creditor needs more quickly and efficiently than under current ad hoc arrangements. Creditor and debtor representatives and advisory groups could be given regular updates and kept current. When necessary, structured processes could be initiated smoothly without reinventing the wheel for each distressed sovereign, while maintaining the flexibility to innovate on specific points. Maintaining a standing SDF with periodic regular discussions on emerging vulnerabilities may also reduce the reluctance of sovereigns to begin such processes, as noted earlier.

OUTCOMES

Enhanced credibility and ownership. By engaging all stakeholders in the sovereign debt realm in ongoing discussion, intimacy and trust would be built among key individuals. By further engaging these people and institutions in a move to consideration of a specific sovereign at an early stage of distress, credibility and ownership of possible adjustment programs and debt treatments will be strengthened. The IMF and sovereign would have a structured standing venue in which to brief on the assumptions, design and content of their adjustment program and the DSA. The primacy of the IMF's role in this analysis would remain unchanged, but ownership of its work by other stakeholders would be enhanced. What's more, political pressure on IMF staff from any one source would either be reduced or balanced by competing interests: program assumptions and design would be subjected to rigorous review. Holdouts would not be eliminated, but they would likely be reduced compared with current processes.

Close consideration of financial sector implications. The SDF would highlight the implications of any possible crisis resolution options for the financial sector. The euro-zone crisis has underscored the close links between sovereign solvency and the banking system.

Voluntary stays of legal action. SDF member creditors could agree to refrain from taking legal action or advancing any pending lawsuits during consideration of sovereign workout. This would be contingent on the sovereign's continued engagement in appropriate conduct, including good faith negotiations, consistent with membership in the SDF. SDF member creditors may also agree to coordinated rollovers in the spirit of the Vienna Initiative and the SDF would be helpful in coordinating such arrangements.

Changes in bond documentation. Consideration should be given to creating processes in which consensual revision of bond documentation can be effected, to the extent possible and necessary, to assist in the implementation of the SDF's work. This could include the insertion in bond documents of CACs, aggregation clauses, engagement clauses and exit consents, as well as by provisioning for the appointment of trustees to assist in the early formation of committees prior to any debt discussions.

THE SDF IN CONTEXT: A COMPLEMENT TO OTHER PROPOSALS

The SDF is a strong complement to a number of other proposals for reform that have been inspired by recent crisis experiences. It would be natural to posit the SDF as part of a suite of pragmatic initiatives that can together address *ex ante*, *in medias res* and *ex post* crisis issues without resorting to agreement on an international treaty or common statutory approach. This package would preserve flexibility for the debtor and the integrity of creditors' rights, with each element of this agenda proposed on a joint or several basis to be pursued alone or together. In this, the SDF could form part of a tripartite approach to reform reminiscent of an outline fashioned by Eichengreen and Portes (1995). The entire package could be structured as follows.

Ex ante proposals:

- The SDF, as outlined in this paper.
- Stricter sovereign borrowing limits. The IMF could undertake stricter oversight of sovereign borrowing as part of its surveillance process (IMF 2013) and, as Schadler (2013) has suggested, place stronger limits on exceptional access to IMF resources; such limits could also be enforced under a set of concerted but non-statutory principles akin to APEC's approach (Bulow 2002).
- Multilateral insurance reserved for debt beneath preordained limits. The Red bond, Blue bond proposal by von Weizsäcker and Delpla (2010) and the European Safe Bonds proposal by Brunnermeier et al. (2011) would be two of many possible examples, with additional options discussed in EEAG (2011), and Hellwig and Philippon (2011). These would provide a clear incentive for sovereigns to self-regulate their debt burdens.

In medias res proposals:

- State-contingent bond contracts or sovereign "CoCos" (contingent convertibles). Linking debt service obligations to national macro indicators or global prices would provide an elegant way to get

beyond judgments of illiquidity versus insolvency: in extreme cases, the contracts would provide automatic standstills and maturity extensions so that liquidity and solvency could be assessed in real-time rather than by abstract forecast (Bulow and Rogoff 1989a; Gunther, Rahman and Shi 2009; Haldane and Kruger 2001; Mody 2013; Brooke et al. 2013).

- Vienna Initiative-style debtor-in-possession financing through automatic rollovers. A global pre-commitment among bilateral and commercial creditors to continue financing to sovereigns and eschew legal action as these sovereigns take initial steps to resolve payments distress could prevent illiquidity during periods of sovereign distress (UN Department of Economic and Social Affairs [UNDESA] 2012).
- Updates to the IMF's lending into arrears policy. Possible reforms mooted in IMF (2013) would, for the first time, bail-in bilateral creditors while ensuring that the IMF could continue to finance distressed sovereigns as a debt workout is arranged.

Ex post proposals:

- Incorporation of enhanced CACs in new bond issues with one-step aggregation features. This would go some way to remedy the type of failure that beset so many CACs in the Greek external-law debt (Buchheit, Gulati and Tirado 2012; Miller and Thomas 2013) treated in 2012, but would likely require concerted support from policy makers (Gelpern and Gulati 2006) for the incorporation of these enhanced CACs in new debt issues.
- Revised euro-zone CAC template. In a similar vein, the new two-step European CAC template is too restrictive and needs to be revised to put less emphasis on supermajorities in individual bond-series, and greater emphasis on activation when reasonable aggregate thresholds are met across all bondholders (Bradley and Gulati 2012; Gelpern and Gulati 2013).
- Any enhancement of CACs should be balanced by accompanying clauses to provide for commitments by sovereigns to engage with creditors in a transparent manner and to assist with the costs of restructuring.
- A compact on structuring bond contracts to enable continued effective use of exit consents could also be considered.
- Immunization of payments systems. The ongoing case of *NML v. Argentina* imperils the integrity of any restructuring completed under the jurisdiction of New York law without the benefit of an international statutory bankruptcy process owing to the possibility of attachment by holdout creditors to service on

restructured debt through payment clearing systems. Belgium has immunized its Euroclear system against such attachment; New York and England, at a minimum, could undertake efforts to pass similar legislation for payments systems based in their jurisdictions. The United Kingdom already did so in 2010 for pre-2004 debt owed by 40 low-income countries, in line with previously agreed debt relief terms.

None of these proposals require unanimous agreement on new treaties or changes to the articles of agreement of existing institutions. The most onerous processes would be engendered by changes to the IMF's lending into arrears policy and the euro-zone CAC template. Aside from these two cases, all other proposals outlined above could be undertaken unilaterally by sovereigns or in concert with like-minded parties.

It is important to underscore that the SDF is not proposed as an initial step toward a statutory or treaty-based approach, but it is consistent with such proposals. Without endorsing any formalized statutory or treaty-based reform proposals, it is useful to recognize that the potential joint or several bundling of incremental reforms proposed above could constitute a useful foundation on which statutory frameworks could be built, should political support arise for such measures (Panizza 2013). These proposals include:

- The Kunibert Raffert/Jubilee proposals for a stand-alone “Free and Transparent Arbitration Process” based on US Chapter 9 bankruptcy proceedings (Kaiser 2013; Raffer 1990; 2005);
- The Paulus/Kargman proposal for the addition of an Insolvency or “Resolvency” Chamber to the International Court of Justice, thereby creating an SDRM-like global insolvency court that would be independent of any creditor, in contrast with the SDRM, that would have been built within the IMF (Kargman and Paulus 2008; Paulus 2012);
- The Brookings/Committee on International Economic and Policy Reform proposal for a Sovereign Debt Adjustment Facility (SDAF) at the IMF and a reform of the European Stability Mechanism's (ESM's) underlying treaty. In both cases, the SDAF and ESM revisions would make multilateral support from either institution contingent on automatic debt restructuring when debt indicators surpass certain pre-identified levels (Committee on International Economic Policy and Reform [CIEPR] 2013);⁸ and
- A fresh attempt to create an SDRM at either the global level at the IMF or at the European level within or

in complement to other European institutions. While no governments or other public authorities have expressed an interest in pursuing this option, some academics and researchers remain ready to assist in an SDRM or Euro-SDRM's creation (Boorman 2006; Buckley 2009; Bulow and Rogoff 1989b; Gianviti et al. 2010; German Council of Economic Experts 2012).

The aftermath of the 2008 financial crisis and the increased relevance of sovereign debt restructuring provides us with an opportunity to advance on some combination of the non-statutory proposals enumerated above, including the SDF. It makes sense to prioritize such incremental efforts ahead of more ambitious proposals that would require international agreement on treaties or statutes, at least for now. After past failures, particularly the rejection of the SDRM, the world needs to show that reform is possible before taking on more ambitious projects.

We need to seize this moment: it would be a great shame to let another period ripe for reform pass without taking action. Proponents of any one of the incremental, non-statutory reforms outlined above could be natural allies in the pursuit of a suite of initiatives. Consideration of these proposals as a flexible package increases the likelihood that at least some set of them will be implemented. A menu or buffet of options will allow policy makers to be opportunistic in seeking consensus to move forward. And an advance on any one proposal will increase the likelihood that the others may follow.

CONCLUSIONS: AN AGENDA FOR ACTION

This paper lays out the case for a realistic reform agenda centered on a proposal for the creation of an SDF to reduce the *ex ante* costs connected to the treatment of sovereign debt crises. It outlines a possible design for the SDF, its operations, its financing and its supporting infrastructure; it explains how the SDF would complement other reform proposals, as well as existing institutions and processes; and it lays out an agenda for implementing the SDF independently or as part of a suite of incremental, pragmatic changes that could also concurrently address the *in medias res* and *ex post* impediments to effective sovereign debt treatments.

The SDF proposal is grounded in the fundamental observation that the enforcement of contracts is not the principal challenge posed by sovereign debt. Contract enforcement is necessarily weaker for sovereign debt compared with lending provided to private borrowers. Sovereign immunity makes it very difficult to seize assets when governments renege on their debt, and most of these assets are shielded within the sovereign's own legal jurisdiction. Moreover, the contracts on debt issued by sovereigns in their own jurisdiction can simply be

⁸ See also Broomfield and Buchheit (2013), Gelpert (2013), Gros and Mayer (2010), Mody (2013), and Weder and Zettelmeyer (2010).

rewritten by the debtor itself. Since the end of the era of “gunboat” collection of defaulted government debt, it has been feared that countries would be inclined to take on too much debt, default on these obligations more often than can be explained on the basis of unexpected shocks, and press for haircuts that are deeper than can be justified by a sovereign’s underlying capacity to pay. In short, sovereigns would naturally tend to default too much, too soon compared with their economic fundamentals. Experience over the last few decades shows, however, that default is a far less frequent phenomenon than concerns about contract enforcement would imply.

Fears of sovereigns defaulting too much, too soon are, in fact, misplaced. Country authorities have generally tended to put off treatment of unsustainable debt burdens, and when they have undertaken restructurings, debt reductions have often been insufficient to make the sovereign’s finances sustainable. Rather than too much, too soon, sovereigns have tended to restructure too little, too late.

The SDF would be focussed on lowering the *ex ante* costs associated with addressing sovereign financial distress in a proactive, predictable and consensus-driven fashion. The proposed SDF would be an independent, non-profit, membership organization open to all stakeholders and constituencies involved in dealing with sovereign financial crises. The SDF would be staffed by a small team of experts that would engage in continuous, dedicated research and consultation to improve the ways in which the international system deals with sovereign financial crises and distressed debt. It would also provide an ongoing venue for regular facilitated discussion on emerging vulnerabilities in the global and national economies, as well as early, structured discussions between debtors and creditors to reach understandings on treating specific sovereign crises. The SDF would complement existing institutions and processes without compromising their respective power or leverage. As an informal and non-statutory arrangement, the SDF would also be consistent with, and supportive of, other proposals currently being mooted to improve frameworks for resolving national and global financial crises.

The SDF would mitigate the tendency of sovereigns to delay dealing with their debt problems in three key ways. First, the SDF would provide the world’s only international standing body solely focussed on the identification of best practice in the resolution of financial crises, which would allow it to advise on the means to make sovereign and creditor processes more predictable, credible and more likely to succeed, thereby increasing the incentive to deal with debt problems expeditiously. As such, the SDF would consolidate the world’s disconnected and sporadic efforts to improve sovereign crisis management with an ongoing dialogue. Second, it would blunt the “trigger problem,” which makes countries reluctant to address incipient crises out of a fear that doing so would set off a self-fulfilling

chain of events. The SDF’s standing facilitated discussions between debtors and creditors would provide a segue to structured negotiations on impaired debt. Third, by creating the conditions and incentives to treat sovereign debt problems proactively, the SDF would improve the odds that genuine liquidity crises can be contained before morphing into all-out solvency crises.

By shifting the focus from fears of too much, too soon to addressing the causes of too little, too late, the SDF would help increase the odds that efforts to assist sovereigns in distress achieve treatments that are just right, just in time. At a minimum, an SDF would do no harm, but successful implementation of this paper’s SDF proposal would potentially create substantial value: it would provide an optimized, consultative workout process that preserves value for both the sovereign debtor and its creditors, and minimizes spillover costs for the rest of the global economy.

The world has a window of opportunity for reform and a set of realistic proposals on sovereign debt that could be championed by developed and emerging markets alike. The pragmatic and non-statutory nature of the SDF and several other proposals is such that any of them could be pursued and piloted on an initially ad hoc basis by individual nations, a small set of countries or an international forum such as the Group of Twenty. It is rare that a meaningful global reform agenda is both so flexible and requires so little hard consensus from the international system. Now is the time for action.

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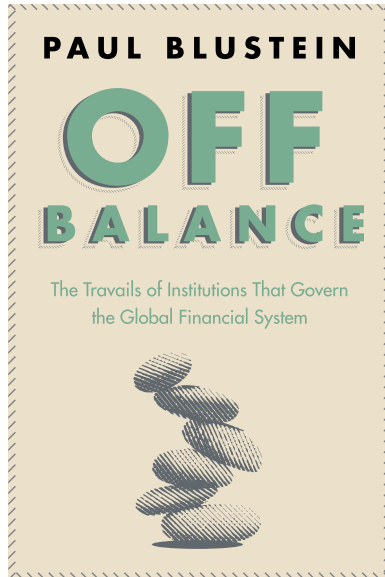
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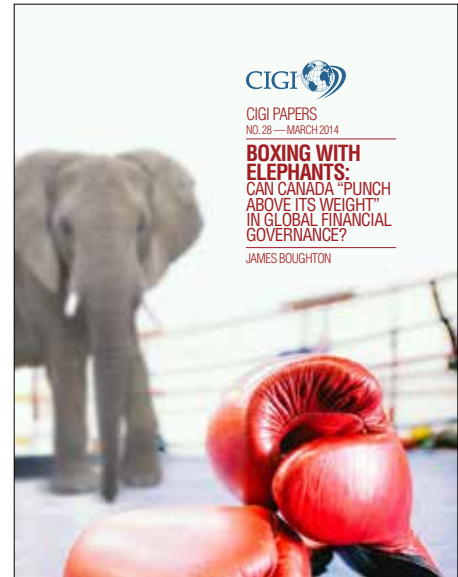


Off Balance: The Travails of Institutions That Govern the Global Financial System

Paul Blustein

Paperback: \$28.00; eBook: \$14.00

The latest book from award-winning journalist and author, Paul Blustein, is a detailed account of the failings of international institutions in the global financial crisis. Based on interviews with scores of policy makers and on thousands of pages of confidential documents that have never been previously disclosed, the book focusses mainly on the International Monetary Fund (IMF) and the Financial Stability Forum in the run-up to and early months of the crisis. Blustein exposes serious weaknesses in these and other institutions, which lead to sobering conclusions about the governability of the global economy.



Boxing with Elephants: Can Canada “Punch above Its Weight” in Global Financial Governance?

CIGI Papers No. 28

James Boughton

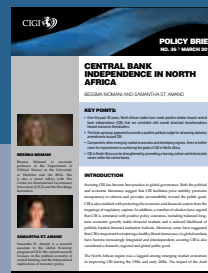
Canadians have long harboured a desire to “punch above their weight” in international diplomacy, an aspiration justified by Canada’s position in the world both geographically and culturally. This paper examines Canada’s role in international financial governance, particularly within the IMF. The key issue for the future is whether Canada will continue to have the capacity and will to take leading positions and actions in the face of increasing competition from the growing emerging market countries.



IMF Policies Post Arab Uprisings

CIGI Policy Brief No. 34
Bessma Momani and Dustyn Lanz

In response to the Arab uprisings in Egypt, Morocco and Tunisia, the IMF has changed its perspective on the social outcomes of its economic policy advice. This is a welcome transition; however, there is still room for improvement. Specifically, the Fund could strengthen its commitment to the social dimensions of public policy by delivering more specific, tangible policy advice for countries to achieve inclusive growth, reduce inequality and improve health and education outcomes.



Central Bank Independence in North Africa

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Bessma Momani and Samantha St. Amand

Over the past 30 years, North African states have made positive strides toward central bank independence (CBI) that are correlated with overall structural transformations toward economic liberalization. This brief argues in favour of furthering reforms by promoting transparency, meritocracy and an open-learning culture to solidify the modest gains made in CBI in the region.



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