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Towards a Comprehensive Sovereign Bankruptcy Regime

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Debt Restructuring and Sovereign Bankruptcy

CONCLUSION: TOWARDS A COMPREHENSIVE SOVEREIGN BANKRUPTCY REGIME

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The argument in this book is that the ad hoc and piecemeal official and market-based insolvency regimes for sovereign debtors have been excessively creditor friendly and costly for developing countries. The "solutions" are generally put into place with undue lags, causing unnecessary prolongation of uncertainty and attendant economic trauma. And, despite ultimately returning the debtor to new financial flows from its traditional creditors, the workouts almost never provide enough relief for a "fresh start" of the debtor economy. This often leads to future debt restructurings, and possibly a long period of stagnation or slow economic growth, with consequent worsening of poverty.

Moreover, as currently constituted, the debt workout regimes treat sovereign borrowers differently, depending on the degree of political power of debtor governments and their willingness to use it, as the Russian and Argentine cases illustrated. In other words, aside from the system's vertical inequities (creditor friendliness), it is also plagued with horizontal inequities that put smaller, less strong or less "strategically" important countries at a disadvantage. The world can do better.

This book has argued that even though governments of some developing countries may need to manage their fiscal accounts and their debt more effectively, even the most prudently managed governments also are susceptible to debt crises. As Claessens and

Panizza indicate in their chapters, there are limits to what national debt management can achieve. Indeed, the experiences of the current world financial crisis show that even in the richest countries' governments sometimes have to cover or take responsibility for debts of private firms that are "too big to fail" or are key components of the financial sector. When the entire domestic banking system is a contingent liability of the government, when financial flows are fully free to leave as to enter, when private banks cease their normal financing of international trade, and when international trade prices undergo huge cycles of boom and bust, the normal benefits of good fiscal management can easily be overwhelmed. This means some governments will have to face the debt workout system at some point in the future. They—and their creditors—should be able to draw upon a more effective and fair system than exists right now.

Creditors use the power they have

Our claim of creditor friendliness in debt workouts in the present system was based on a broad range of experiences. We saw it in the delay in the 1980s in resolving the emerging economy debt crises until the commercial bank creditors were in a position to absorb losses that could no longer be postponed, as described by Garay. We also saw it in the high returns to private investors in sovereign bonds, which Spiegel traces to the need to make a "cooperative" restructuring swap attractive enough for bondholders to voluntarily accept it. One may see it as well in the terms proposed by the private sector in its "code of conduct" for ideal workout processes, as described by Herman. But we have also seen that voluntary cooperative sovereign debt restructurings have not put countries into a sustainable debt situation; i.e., they have not given them a "fresh start", a term we take as a proper objective of an insolvency system, and as the usual goal under national regimes for firms exiting from bankruptcy (as opposed to being wound up), as emphasized by Stiglitz.

In addition, we saw that the system for restructuring the official loans of developing countries was also biased towards the creditors, as it did not as a general rule provide sufficient debt relief to countries to renew sustainable growth and avoid the need for them to go back to the negotiating table. The exception to the rule is the handling the debt problems of 41 heavily indebted poor countries (HIPCs), albeit arrived at a decade after the program began, as traced by Cosío-Pascal, and as Martin illustrated for Ethiopia. The debt of the HIPCs has been a special case, subject to considerable and prolonged civil society pressure that succeeded in increasing the amount of relief accorded. Today the debt workout processes for these countries have essentially been merged into the foreign aid regimes of their donors, as discussed by Northover. Henceforth, the financial relationships of these debtors are to be governed by donor/recipient partnerships. This notwithstanding, the International Monetary Fund (IMF) and the World Bank estimated in August 2008 that thirteen of the 23 HIPCs that had exited from the program still had either "moderate" or "high" risks of debt distress (IDA and IMF, 2008), and this was before the global economic downturn gathered its awful momentum. One may wonder how other low-income countries that have been outside the HIPC Initiative, but that also service considerable foreign official debt, will be treated if and when their time for a debt workout arrives.

Although private and official creditors have been able to turn the current debt workout regime to their advantage, it can also be argued that a comprehensive and fair international debt workout regime that better balances the interests of debtors and creditors would also be in the interest of creditors, and possibly even yield superior outcomes. For example, if countries fearing debt distress felt confident that a debt workout would be fair and effective, they might well seek it out before piling on more and more debt on less and less advantageous terms until the creditors stop lending on any terms. An earlier debt workout would require less write off of creditor claims because there would be less debt than has been the practice when governments seek to postpone the day of reckoning for as long as possible (one concern that motivated Bolton and Skeel's proposal). Moreover, in the same way that at the corporate level creditors appreciate the value of a bankruptcy judge who can prevent managers from stripping the firm's assets, as well as stay litigation by individual creditors in the interests of the creditors as a group and "cram down" a majority-agreed workout on recalcitrant creditors, so too most creditors should appreciate how a sovereign bankruptcy regime could also serve their interests as a group. If the creditors nevertheless oppose introducing such a regime, it must be that they think that they can do better as individual creditors, either by "beating the system" or because they do not trust that the outcome of the system will be "fair" from their perspective.

The irony is that not only creditors but also debtor governments have opposed introduction of a sovereign debt workout mechanism. In a recent study, Eric Helleiner delved into four attempts to create a sovereign debt workout mechanism from the 1930s to the present (Helleiner, 2008). Two of the four attempts were proposed or advocated by debtor governments, namely at the Pan-American Conference in Montevideo in 1933 and the initiative in the late 1970s at the UN Conference on Trade and Development. In both cases, however, debtor governments split on the proposals with some strongly opposing the initiatives, fearing adverse impacts on their access to credit. As creditor governments also opposed the initiatives, they failed. The other two attempts at creating a comprehensive international debt workout mechanism were killed by developed countries, or more precisely by opposition within the government of the United States (even though the proposals had been initiated by other US officials). The first proposal was that of Harry Dexter White in the early drafts of what became the Bretton Woods agreements in 1944 and the second was the proposed Sovereign Debt Restructuring Mechanism (SDRM) proposed at IMF in 2001 with encouragement of the US Treasury Secretary, and later opposed both by his successor and the entire financial community. The latter was also opposed by several emerging market governments, which feared giving a signal to the market that they would ever contemplate defaulting on their financial obligations. It appears to us, especially seen from the depths of the financial collapse of the private financial institutions themselves, that this fear was overwrought.

Towards an international debt workout mechanism

In early 2009, as this book goes to press, financial regulatory reforms that were unthinkable a year before are being seriously considered in international forums. It thus seems to us appropriate to also seriously consider changes in the process for sovereign debt workouts. What criteria, then, should a reformed system satisfy?

While countries in different circumstances will need different degrees of relief, the principle of providing sufficient relief for a “fresh start” should be the universal criterion. The aim should be a *single system for relief*, which should embody mechanisms for debtors to talk with their creditors with the goal of reaching a *timely and comprehensive debt restructuring* that gives the debtor country economy room to grow. The poorest countries may require special treatment to support their recovery after crises and attain the international development goals by applying forms of assistance that do not compromise their debt sustainability; indeed, it may be better to leave this task to the *aid* regime — i.e., official development assistance — rather than to the debt restructuring mechanism.

With a view to realizing a comprehensive workout, the debt workout mechanism should also encourage the creditors to coordinate their positions within and across different classes of lenders (including the government creditors that operate today through the Paris Club). A well-designed process should protect the rights of minority, as well as majority, creditors. It should give debtors the opportunity to call default through a structured process. Equitable treatment of the debtor and its creditors, and of different creditors and debtors, should apply equally to all countries. As in national bankruptcy systems, principals should be encouraged to reach a workout on their own to the extent possible.

The principle of a fresh start and equitable treatment should be understood in terms of human development. So, debt restructuring should not only aim at facilitating an economic recovery but at guaranteeing especially that the burdens of adjustment do not severely affect the disadvantaged in society. Equitable treatment should also recognize that the contractual and legislative commitments of the debtor government to citizens, as for pensions and unemployment insurance, are also government liabilities, warranting representation of these stakeholder interests in the debt renegotiation process.

The system should also be empowered to distinguish obligations of the government from those of corporate entities that the government temporarily takes over during crises. This also means that strictly private liabilities should not be "nationalized" through the pressure exercised by foreign creditors, increasing the burden on the taxpayers of debtor countries. This has unfortunately been a practice in developing country financial crises, and has added substantial amounts of private sector debt to the sovereign's obligations. For this reason, the external liabilities of nationalized financial institutions should be treated as corporate debts that should be renegotiated as such, as part of the cleaning of the balance sheet of the institution involved, and therefore not added to the public sector debt.

Realizing these objectives requires a more structured framework for international cooperation. For the same reason that formal bankruptcy regimes—not voluntary processes—resolve corporate insolvencies, an efficient sovereign insolvency system requires something more than a moral appeal to cooperate. In fact, powerful states can usually be found to impose discipline on private creditors when needed for workouts from major financial crisis. While concerted meetings of bankers may have saved Korea from default at the end of 1997 and rescued the US financial markets from the challenge of Long Term Capital Management in 1998, it is important to recall that the concerting was done by the Federal Reserve Bank of New York and the US Treasury. US authorities were also at the centre of the management and eventual "resolution" of the Latin American debt crisis of the 1980s, although placing the recovery of the developing countries involved second to the objective of avoiding a bankruptcy of the US banking system. Perhaps the last time the private sector rescued a country from financial crisis was when J.P. Morgan coaxed some of his banker friends to work with him to finance the workout from the U.S. financial panic of 1907. That experience, however, prompted the US authorities to create the Federal Reserve System.

A sovereign bankruptcy regime meeting the preceding criteria can be conceived in terms of different structures. There are two major approaches in this area. The first would be an International Debt Court**,** created as an independent body that would be in charge of implementing an international agreed debt workout mechanism, which could be overseen by a representative board of directors. The Court would ensure that agreed international principles regarding the priority of claims against the debtor government, write downs necessary for a fresh start, and equitable sharing of 'haircuts' were followed. It would also have the authority to ask creditors to provide new financing to the country undergoing debt restructuring (similar to the "debtor in possession financing" in corporate restructurings), which would have seniority over defaulted debts. Other creditors (including international financial institutions and governments) that provide financing while the debt standstill is in place would also have such seniority. National courts would have to recognize the legitimacy of the international court, and therefore should respect its rulings. The Court would deal primarily with sovereign debts, but could also provide a forum to treat private sector debts that are “nationalized” during crises or private debts that have systemic implications for the country involved (particularly because they generate balance of payments problems).

The second alternative would be to empower a global financial institution to act as an impartial advisor and “honest broker”, encouraging but not involving itself in direct debtor/creditor negotiations. Its role would therefore be that of a mediator but could also be given arbitration powers. It could also deploy its own financial resources for countries in need, as the IMF has traditionally done. It is important to emphasize, however, that the IMF is unlikely to be seen as a “neutral mediator”, as was proposed during the failed negotiations of the SDRM earlier this decade, as it is also a creditor and its governance structure is today dominated by creditor countries. However, if this responsibility is given to the IMF, the mechanism could function through a system of independent panels of experts, similar to those used under the dispute settlement mechanism of the World Trade Organization. The panel would take the responsibility for mediating the negotiation between the debtor and its creditors and ultimately determine the solution, following agreed international policy guidelines.

There can also be a mix between these two approaches. For example, the Fund or the independent panel could first seek to facilitate voluntary debtor/creditor negotiations for a limited time period, after which it would refer the case to the International Debt Court.

Approaches such as these were endorsed by the recent Commission of Experts on Reforms of the International Monetary and Financial System convened by the President of the UN General Assembly (Stiglitz Commission), based in part on ideas developed in this volume.

An international political process will necessarily be at the centre of developing any framework of cooperation in this area. While any workout for a country in distress must have economic and judicial soundness, there is every reason for the international community to give guidance as well to the goals of relief, in particular as regards what constitutes a "fresh start" and what is required to reach internationally agreed human development goals. As was seen in the special treatments in the Paris Club for politically important cases, or in the history of the HIPC and Multilateral Debt Relief Initiatives, governments do not shy away from acting collectively to achieve political goals through international institutions when deemed necessary. In fact, principles and priorities with important development and social dimensions are already agreed internationally and governments should not hesitate to apply them fairly across the board. These are shared political goals as much as financial stability and international equity. Incorporating such considerations of fairness and developmental effectiveness into a new sovereign insolvency workout mechanism would boost its credibility with debtors — indeed with all stakeholders, including creditors who should appreciate the reduction of uncertainty under clear rules of the game and the knowledge that any post-workout debt situation would at least start out being sustainable.

It is time to act

We are not the first to reach the conclusion that the sovereign insolvency system should be replaced, as the reform proposals of recent decades that Kaiser reviewed makes clear. But those proposals have not been accepted politically and thus we need to continue to seek workable designs for a comprehensive international mechanism that is more efficient and fair in economic and social terms than what we have. Looking at the failed attempts at reform in the past, especially the SDRM, as discussed in the chapters by Setser and Gelpern and Gulati, one may also conclude that the most assured path to realizing the goals of reform is a more open strategy for creating the reform. This involves first fostering discussion and building momentum behind a concept of the structure; second, drafting the details; and third, winning consensus support. This seems the only way to proceed. The current world financial meltdown may be the opportunity to begin the process in a serious way.

In the Monterrey Consensus, approved in the 2002 International Conference on Financing for Development, all governments, both from countries that are home to international private creditors as well as debtors, have already agreed at a general level on the importance of “putting in place a set of clear principles for the management and resolution of financial crises that provide for fair burden-sharing between public and private sectors and between debtors, creditors and investors.” The governments also said they “would welcome consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner” (United Nations, 2002, paragraphs 51 and 60).

The SDRM discussions in 2002 and 2003 showed the international commitment to consider creating such a mechanism had real force. After the SDRM was rejected, “multi-stakeholder consultations” on sovereign debt issues were organized by the United Nations in collaboration with the IMF and World Bank and other multilateral, private sector and civil society partners (see United Nations, 2005).While those discussions were reported to the UN General Assembly, there was no intergovernmental follow up. Nevertheless, the World Summit held at the General Assembly in 2005 reiterated the international call to consider the “exploration of mechanisms to comprehensively address the debt problems of [developing] countries” (United Nations, 2005a, paragraph 26c). Again, there was no follow up. And yet in December 2008 in Doha, Qatar, at the Follow-up International Conference on Financing for Development, governments of debtor and creditor countries agreed once again to “consider ways to explore enhanced approaches of sovereign debt restructuring mechanisms…” (United Nations, 2008, paragraph 67). It seems that the world’s governments can agree in principle again and again on what needs to be done. It remains for them to actually do it.

It is understandable if creditors and debtors hesitated to develop a concrete proposal after the SDRM was rejected. Each side, but especially creditors, could fear being weakened under a new regime. And, during the boom years of the present decade, countries may have convinced themselves that they did not need to think about sovereign insolvency. That was and is a mistake.

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