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Some Comments on the IMF Paper on Restructuring Sovereign Debt

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The IMF paper makes an important contribution in recognizing the costs of delays in and uncertainty about restructuring, and in noting both the inadequacy of the current regime as well as a strictly contractual approach. The IMF paper also rightly emphasizes the importance of providing new finance and a stay in litigation during a period in which a resolution is being worked out, and the possible necessity of imposing capital controls. The IMF paper recognizes some of the limitations in its roles in the bankruptcy process—as a major creditor, it cannot be viewed as an impartial "judge".

But the IMF paper fails to note the importance of other conflicts of interest, the conflicts of interests among different creditors (including across different instruments) and the conflicts of interests between creditors and debtors. In recent cases, conflicts between those with dollar denominated debts and domestically dominated debts have played an important role. There are also important differences in interests between resident and non-resident creditors, but a given bond issue may be held by both resident and non-resident holders, and it would seem to be difficult to allow one category to vote but not the other. Even without deliberate manipulation, it may easily be the case that domestic holders may be in a majority, and may vote for a resolution which advantages them at the expense of foreigners, especially since domestic tax and other laws may provide for forms of compensation that are not available to foreign creditors (or the opposite situation may also prevail.) Similarly, while recognizing that there are public good aspects to a bankruptcy resolution, it fails to note the problems that arise in voting as a means of addressing the need for collective action.[1]

It recognizes that in private bankruptcy proceedings, typical bankruptcies are resolved as a result of bargaining between and among creditors and the debtor *against a legal backdrop,* but it fails to emphasize the important role that the legal backdrop plays. The outcome of the bargaining process depends crucially on how the courts might act, were the resolution turned over to the courts. This is, of course, precisely why bankruptcy law is so important, and so controversial. Chapter 11 is widely viewed as far more debtor friendly than chapter 7 (or bankruptcy provisions in many other countries), implying that the resolution that emerges from bargaining with chapter 11 as a backdrop is likely to be more attentive to debtor interests. (While many economists might argue that such a provision is also better for overall economic efficiency, it is clear that there is not unanimity on this matter.)

Nor does it recognize that even in proposals concerning it playing a more limited role, such conflicts of interest remain. As a senior creditor, issuances of credit by it may adversely affect the interests of other creditors, even if they enhance the overall viability of the economy and the value of IMF loans. Other policies may have different effects on senior and junior creditors. Voting power within the IMF is still concentrated within the creditor countries, and direct government representation, from central banks and finance ministries, is accordingly particularly attentive to the concerns and perspectives of finance.

The IMF report, while recognizing the limitations of market mechanisms for the design of contractual provisions, does not sufficiently recognize the limitations of market mechanisms, even with collective action clauses, in the bargaining process. While it recognizes the ambiguous role that the possibility of funding may have on this process (the possibility that funding may delay a resolution, as arguably happened in East Asia, when many creditors held off in the hopes that additional funding would enable them to obtain more favorable terms; but funding conditional on speedy resolution can presumably facilitate a resolution), it does not fully recognize the incentives for delay in bargaining models; nor does it fully recognize the dangers that arise in majority voting, especially when different classes of creditors are aggregated.

[1] Especially those that arise in the context of corporate decision making, where the voters are "endogenous."