



Initiative *for* Policy Dialogue

Based at Columbia University 

## *Working Paper Series*

# Dealing Deftly with Sovereign Debt Difficulties

Barry Herman

Task Force on Debt Restructuring and  
Sovereign Bankruptcy

*The opinions expressed in these papers represent those of the author(s) and not The Initiative for Policy Dialogue. These papers are unpublished. Do not cite them without explicit permission from the author(s).*

# DEALING DEFTLY WITH SOVEREIGN DEBT DIFFICULTIES

Barry Herman\*

## Contents

Why sovereign debt crises happen and how the world responds.....	3
Sovereign debt crises as an international policy problem.....	5
Systemic threats in debt crises .....	8
Initiative for the Heavily Indebted Poor Countries.....	10
What should the debt level be after a debt crisis workout? .....	15
Market test .....	15
Macroeconomic assessment.....	17
Social and political dimensions .....	19
Limits of analysis.....	22
Organizing the players for the debt workout .....	24
Paris Club reform.....	24
Organizing the private creditors.....	26
The search for a comprehensive approach.....	31
Conclusion .....	37
References.....	38

Sovereign debt crises are the result of mistakes of judgement, albeit judgements made in an inescapably uncertain domestic and international economic and financial environment. A sovereign debt crisis arises after a government borrows amounts over time that create interest and principal repayment obligations that — sometimes for domestic and sometimes for international reasons — it “cannot” meet because to do so would require some combination of unconscionable reductions in public services and punishing payments by its taxpayers. Creditors share the blame in a debt crisis, as they will have collectively lent more than they should, either not anticipating that the repayment capacity of the borrowing government could become so weak or assuming falsely that some other creditors would bail them out.

---

\* Senior Advisor, Financing for Development Office, United Nations Department of Economic and Social Affairs (contact: herman@un.org). Views expressed are those of the author and not necessarily of the United Nations. Comments on an earlier draft by Nancy Alexander, Bernhard Gunter, Eva Hanfstaengl, Joseph Anthony Lim and Benu Schneider are much appreciated.

This paper looks at the international process for overcoming such crises. It first characterizes the nature of sovereign debt crises, and how their resolution has fallen under the domain of global policy. It then highlights the complexity of determining how much debt a post-crisis country should end up with and how the major players interact in determining the actual workout in typical cases. It concludes by considering certain proposals for improving the chances that debt workouts will be effective, speedy and fair.

In all, the message in this paper is that sovereign debt crises are international political problems involving on the one hand the governments of the major economies, which represent or are themselves the creditors, and on the other hand the developing or transition economies in difficulty. The different ways the crises have been addressed reflect the relative importance of different groups of creditors in the defaulted debt. In this sense, the creditors drive the process, which is understandable, as the defaulted funds are owed to them. The people in the crisis countries have the least influence in shaping the process and usually pay most dearly for the crises. Overall, the approach has been reactive and largely ad hoc. This paper argues instead for developing a more comprehensive international approach for dealing with sovereign debt difficulties that would be more attractive to all the relevant parties.

### ***Why sovereign debt crises happen and how the world responds***

When a government borrows in its own currency and then runs into repayment difficulties, it has an alternative to defaulting on its outstanding debt. This alternative has been available for centuries to sovereigns willing to debase their currency by issuing coins of the realm with reduced amounts of precious metal. In modern days it takes the form of covering the government's deficit with inflationary rates of money emission. These options do not exist when the government borrows in foreign currency, and thus foreign lenders — official as well as

private — usually demand that their loans be repaid in an international currency.

A sovereign debt crisis begins when a government is unable to make its next foreign interest or principal payment. If the government were a private enterprise, a default on its obligations to creditors would likely lead to bankruptcy court and either a corporate restructuring under a judge's supervision or a winding up of the company, sale of its assets and distribution of the proceeds to cover some of the claims of the creditors. Neither option is available in the case of sovereign default. There is no global bankruptcy court for governments. Even if there were, there is no global government to enforce such a court's judgements. Governments are sovereign.<sup>1</sup>

Nevertheless, sovereign debt crises happen and governments need to work out from under them. Exit from the crisis usually requires some restructuring of the government's obligations, which may range from refinancing the debt or a negotiated agreement with the creditors to postpone principal repayments in mild cases to actual debt forgiveness in severe cases.<sup>2</sup>

Sovereign debt crises are probably as old as sovereign states, although the creditors have changed through the centuries. Today, the main creditors are internationally active banks, pension funds and other institutional investors, individual corporate or household buyers of foreign government bonds, and a range of creditors operated by other governments, including national export credit and development assistance agencies, plus multilateral institutions such as the International Monetary Fund (IMF), the World Bank and regional financial institutions.

---

<sup>1</sup> For an elaboration of the comparison of private and sovereign insolvency, see Herman 2003a, pp. 67-69.

<sup>2</sup> A government might have to restructure its domestic debt as well as its foreign debt in a debt crisis, in particular when it cannot use the inflationary option because the monetary authority has been made fully independent of the government or when the government has guaranteed the foreign exchange value of domestic currency debt. This paper will not address such cases as they are less common and add complications without adding major new points to the story.

### ***Sovereign debt crises as an international policy problem***

In the era since the recovery from the Second World War, sovereign external debt crises have occurred exclusively in developing countries and countries with economies in transition from state to market (i.e., countries that had been within the former Soviet orbit). All of the crises were resolved under international policy regimes, as they were highly disruptive socially and economically and — especially during the tense period of the Cold War — they were sometimes seen as a potential threat to global political stability.

As international lending at first was mainly carried out by official creditor agencies or was guaranteed by them, the creditor governments needed to cooperate among themselves to arrive at the overall amount of relief to accord and how to share that burden among themselves. Hence, the major government creditors formed the Paris Club, an informal arrangement serviced by the French Treasury, to negotiate collectively with individual debtor governments, initially with Argentina in 1956. IMF works with the Paris Club, giving it guidelines for how much relief is needed in each case, although the Club decides independently on the extent and terms of relief. As the 1960s turned into the 1970s, 1980s and 1990s, the governments of developing and transition economy countries borrowed increasingly from foreign private sources. However, the major creditor governments, individually and through IMF, continued to be regularly involved whenever a government had difficulty meeting its obligations to its foreign private creditors, as with its official creditors.

Private lending has typically taken place in cycles in which a burgeoning and lucrative business in transferring private savings from rich countries to the governments of poor countries becomes excessively risky, provokes a “flight to quality” (meaning funds flow to safe havens in developed countries), new lending stops and debt crises start. The downward part of these cycles

put great strain on the crisis countries. The positive net transfers of financial resources to them during the upward part of the cycles reverse direction and become net transfers back to the creditors and investors, paid for out of compressed domestic expenditure.<sup>3</sup>

A common scenario that leads to a sovereign debt crisis involves a widening fiscal gap resulting from the government spending more than is consistent with average tax revenues. This scenario could begin in an economic boom when tax revenues are strong, prospects appear good, and foreign creditors are ready to lend on easy terms. When the economic situation weakens, the fiscal gap rises from the heightened expenditures, from increased debt-servicing obligations owing to the new borrowing and from slipping tax revenues. This makes creditors tighten the terms of new loans. As this continues, it becomes harder and harder to arrange necessary financing to close the fiscal gap, until the flow stops and the crisis ensues.<sup>4</sup>

In an alternative scenario, some natural calamity could strike, like a major earthquake or drought, and cause a serious economic setback, or the cost of essential imports (such as petroleum) could unexpectedly rise relative to export prices (a terms-of-trade deterioration). Such events could precipitate the downward phase of an economic cycle in a developing economy, while requiring additional government expenditure to assist the people hurt by the physical calamity or economic difficulties, which in turn would mean increased borrowing and

---

<sup>3</sup> The “net transfer of financial resources” refers to the difference between net financial inflows to a country and net investment income payments and capital outflows, taking together all types of financial flows in and out of the country, including investment, lending and official assistance (including grants). A positive “net transfer” thus means a country is importing more goods and services than it is exporting, which is to say total domestic expenditure is larger than production. A “normal” pattern begins with positive net transfers to a country in early development stages turning into negative or net outward transfers when the economy matures, domestic savings rise significantly and the need for foreign borrowing subsides. In a debt-crisis pattern, a loss of creditor confidence in the country cuts off the net financial inflows and starts the net outward transfers while savings rates are still relatively low, forcing domestic expenditure to be compressed to free up the resources to make the net outward transfer. The United Nations Secretariat regularly monitors the annual net transfer of financial resources to and from groups of developing countries (see UN 2003, pp. 41-49).

<sup>4</sup> In recent years, the highly “pro-cyclical” nature of private foreign lending, as well as commodity price booms being temporary, has heightened the importance of policy makers following a medium-term fiscal framework to help steer their economies through the ups and downs of economic cycles (UN 2003a, pp. 6-8).

then more debt servicing.

In addition, sometimes a country is hurt by a debt crisis in another country. That is, some debt crises have been contagious viruses, as when Mexico's 1994-95 debt crisis caused great strain in the market for Argentine bonds — although the effect is not necessarily symmetrical and the market learns over time, as when Argentina's crisis in 2001 did not seriously affect Mexican debt. Contagion could also erupt when lenders to countries in crisis cover their losses by suddenly selling their loans to other countries, driving down their prices and raising the interest cost of rollover and new borrowing by the other countries, threatening their own debt sustainability.<sup>5</sup>

When developing countries borrow in foreign currency from foreign private banks, they usually pay a base interest rate keyed to the borrowing rate of the government of the foreign country, reset each six months, plus a risk premium. The fiscal situation of the developing country is thus vulnerable to an increase in foreign interest rates that have nothing to do with the developing country situation. Moreover, if the local currency is devalued, a typical outcome, the government's foreign debt-servicing obligations become all the more difficult to meet out of local revenues. Indeed, in some cases, the government may accept to take over the foreign currency obligations of its local commercial banks, which could otherwise be rendered bankrupt by the devaluation, which would add the banking system's foreign debt to that of the government. Thus, whether or not a developing country is profligate, a significant fiscal deficit and associated debt build-up may emerge, owing to endogenous and exogenous factors.

As the national economic situation deteriorates in a crisis country and the country's

---

<sup>5</sup> Although not sovereign debt crises per se, the workings of contagion were especially prominent in the Asian financial crisis of 1997-1998. See Rude (1999) for how that crisis was perceived in the New York financial markets and Sharma (1999) for a view from the East Asian markets.

creditors see excessive risk in continued lending, the government usually approaches IMF for assistance (sometimes before and sometimes after default). This brings the burgeoning difficulties between the government and its private creditors solidly into the international policy arena. The *quid-pro-quo* for IMF assistance is that the government enters into a policy agreement with the Fund, pledging to undertake specific policy changes meant to correct the problem that has worried the creditors. IMF then permits the government a regular loan or a drawing from the Poverty Reduction and Growth Facility, a concessional window for low-income countries. Other official creditors may also increase their support of the country.

The amounts lent in this context by the international public sector are meant to ameliorate the situation, but they far from “bail out” the people of the country from the painful economic contraction that accompanies the crisis. On the other hand, as very large amounts of official funds were lent in the 1990s to certain countries, critics charged that IMF and other official creditors were bailing out the foreign private creditors, who took advantage of the official resource inflows to finance their own exit. It has also been questioned whether they have lent too much and for too long in some unpromising — if politically important — situations. As a result, today, stricter limits are placed on IMF lending and it is expected that private creditors will fully participate in the workout from a crisis through provision of new credits or by restructuring their debt-servicing obligations. This, in turn, puts a greater premium on having what is seen by all parties to be an effective, fair and speedy mechanism for organizing debt workouts, a concern to which we return at the end of the paper.

### ***Systemic threats in debt crises***

Debt crises in “emerging economies” have been a focus of international policy attention not only because of the damage done to the countries themselves, but also because sometimes

they have threatened the world financial system itself. This ensured that the major economic powers would be heavily involved in the debt workouts, led in particular by the United States as leader of the group of major industrialized countries and the largest shareholder of IMF. The Fund itself was asked to provide the analytical oversight of individual cases, introduce new crisis prevention programmes, and monitor their implementation.

In the early 1980s, the systemic threat involved the world's chief money centre banks, which were dangerously exposed to shaky and defaulting developing country debt. At that time, most of the world's international currency transactions went through those banks. The threat of their bankruptcy created a systemic imperative for the international rescue operations of the defaulting countries, which in fact bought the time needed to strengthen the international banking system. Ultimately, a number of the big banks disappeared through mergers and acquisitions.

By the end of the 1980s, with the international banks less vulnerable, the debt crisis was resolved through the "Brady Plan", a creative approach from the US Treasury that gave multilateral official support to restructuring negotiations between debtor governments and committees representing their commercial bank creditors (called "London Clubs," or Bank Advisory Committees when based in New York). The Brady Plan also hastened the development of external bond finance for developing countries as the non-performing bank loans were swapped into "Brady bonds" whose principal and sometimes part of their interest was guaranteed by US Treasury securities purchased with the proceeds of special loans from the multilateral institutions. An active market in Brady bonds helped whet the appetite of institutional investors for other emerging economy sovereign issues.

In the late 1990s, however, a new systemic breakdown scenario threatened. The Russian Government had made several large issues of high-yield securities that were bought up by

foreign investors. Because the securities were rouble denominated, investors relied heavily on inter-bank dealings with weak Russian banks to convert rouble into dollar investments. When the Russian Government defaulted, the effect rippled through European and American financial markets and so raised overall market insecurity as to change yield patterns in United States Treasury securities. Massive financial losses suddenly resulted in the autumn of 1998, especially of “hedge funds”, notably the now infamous Long Term Capital Management, which had bet vast amounts of funds that it borrowed from commercial banks on Treasury yield patterns. As liquidity drained from the market for US Treasury bills and bonds, the largest in the world, it became frighteningly clear that the greater interconnectedness of financial markets by the late 1990s had seriously increased systemic fragility.

The bond-based sovereign crises have been resolved in more ad hoc ways than the bank-debt crises, as will be discussed below. Suffice it to say here that the major powers and the international policy community at large remain engaged on strengthening crisis resolution policy for sovereign borrowings from private markets.

### ***Initiative for the Heavily Indebted Poor Countries***

Of course, there have been many sovereign debt crises that have not threatened systemic damage and they too remain an international policy concern. In these cases, mainly in low-income countries, sovereign debt crises have primarily involved the suspension of servicing of official credits, as official lenders have been the source of almost all their external loans. Largely reflecting intergovernmental as opposed to market relationships with a sovereign, resolution of these debt crises has been especially drawn out. One aspect of this is that the amount of debt relief accorded in a Paris Club agreement has usually been too little to return the crisis countries to sustainable debt configurations and repeated visits to the Club for additional relief became the

norm for quite a number of countries.

Indeed, citizen concern in creditor countries about the excessive debt levels of poor countries burgeoned in the 1990s owing to the link seen between their deepening poverty and protracted debt difficulties. These situations were especially galling because the excessive debts often resulted at least in part and sometimes primarily from loans by the multilaterals themselves in support of “Washington Consensus” policies that were supposed to have raised debtor-country incomes and reduced poverty in their countries.

This anomaly spurred broad popular movements that pressed the world’s governments to alleviate the existing debt crises and prevent future ones. On the heels of the “Fifty Years is Enough” Campaign and with new leadership at the World Bank, the British and other proposals of 1994-1995 led to the Heavily Indebted Poor Countries (HIPC) Initiative in 1996. Then, as the world moved closer to the millennium “jubilee” year and as disappointing initial experiences with the HIPC Initiative accumulated, an enhanced version of the Initiative was adopted in 1999.

The Initiative nevertheless remained and remains controversial. Much critical attention has focused on the multiple hurdles over 6 years, more or less, that each HIPC has to pass before getting permanent relief and thus the slow progress of HIPCs through it.<sup>6</sup> Also, the criteria for eligibility for the Initiative have been called inappropriate in terms of levels of indebtedness and poverty (e.g., Gunter 2003). Moreover, the manner in which the Initiative sought to reduce debt obligations to the multilateral development banks has also drawn criticism. Most importantly,

---

<sup>6</sup> Under the HIPC Initiative, a country needs to demonstrate a “track record” of good policy for a period of 3 years, which includes implementing an agreed IMF adjustment programme during this period, after which it will be deemed to have reached the “decision point” in the HIPC process. At that point, a debt relief requirements analysis is made and interim relief begins to be given. After an appropriate length of time (originally 3 years but now a variable period) of continuing satisfactory policy performance, including developing a Poverty Reduction Strategy Paper in a participatory domestic process, the country can reach the “completion point” (for regular status reports and related information, see the HIPC webpage at <http://www.worldbank.org/hipc>).

however, in adopting the HIPC Initiative the major creditor governments and institutions acknowledged that even complete write-off of all the bilateral debts of the HIPC countries would not have removed their debt overhang and that debts owed to IMF, the World Bank and regional development banks also had to be cut.

Special initiatives to reduce debt-servicing obligations to the international financial institutions were necessary because of the “preferred creditor” status of these institutions. That is, governments borrowing from the institutions are required to fully service their loans to them before all others and the institutions never write off such loans or consider defaulted debt as uncollectible (although they provision against bad debt as is standard practice in financial institutions). Moreover, most official creditors will not lend to a country that is not in good financial relations with IMF, which is to say it cannot have arrears to the Fund.

Under the HIPC Initiative, three major ways were found to pay down the multilateral obligations of the HIPC countries. In none of them do any of the institutions actually acknowledge a loss. At IMF, the innovation was to undertake an indirect revaluation of some of the Fund’s gold holdings in 1999-2000 from 35 “special drawing rights” units per ounce (about US \$50) to the market price of several hundred dollars per ounce and sequester the capital gains from the transaction in a special trust fund, the earnings from which would help cover HIPC repayment obligations to IMF. The other main innovation was to establish a special HIPC Trust Fund at the World Bank, into which is placed some of the profits of the Bank. Both trust funds also receive contributions from individual donor governments for use in covering HIPC obligations to these and other multilateral institutions, which is the third source of funds.

An important question is who actually pays for these special mechanisms. In the case of IMF, the capital gains on the gold revaluation belong to the Fund as a whole and thus to its

member governments in proportion to their ownership in the Fund. As the developed countries hold over 60 per cent of the “quotas” in the Fund, they can be said to be the primary contributors on this score, although the developing and transition economies, *ipso facto*, pay almost two fifths of the total. World Bank contributions to the HIPC Trust Fund come from earnings on loans, which are exclusively to developing and transition economies and thus these countries pay all of it. Bilateral donor contributions essentially come from their aid budgets and should otherwise have been available for direct assistance to developing countries.<sup>7</sup> For the most part, in other words, the non-HIPC developing countries and transition economies pay for the HIPC Initiative.

There is, moreover, a curious thing about the HIPC initiative. Despite very considerable programmed relief (most of which has yet to be disbursed), debt servicing is not projected to fall. Indeed, based on the most recent estimates of IMF and the World Bank, for the 27 countries that had reached the intermediate stage in the process (the “decision point”), average debt servicing during 2003-2006 was projected to be 10.5 per cent higher than in 2001-2002.<sup>8</sup> This reflects the accumulation of arrears by some countries in the early period and the assumption that none are added in the second, as well as the expiration of 5 and 10-year grace periods on earlier multilateral credits. It also reflects that some of the early relief accorded to these countries was in the form of rescheduling and that their grace periods were expiring during the second period,

---

<sup>7</sup> Relief from bilateral official debt servicing is also generally taken from development assistance resources by donor countries. Moreover, when bilateral development assistance loans are forgiven, they are accounted as a grant to the debtor country that is used to pay off or service the loan, meaning there is no net flow of resources. As most bilateral aid is already in the form of grants, however, this accounts for less than 10 per cent of overall bilateral debt relief (Cohen et al. 2004, pp. 31-32). A greater accounting issue is that the debt (bilateral, but also multilateral) is written off at its full face value, when the probability of ever being fully repaid by the HIPC government is small, and thus the budgetary charge for the relief overstates its actual value (*ibid.*, p. 49). In this context, to the extent that development assistance data of donors include bilateral debt relief and contributions to multilateral relief, they are overstated.

<sup>8</sup> There is a lesson here in data reporting. In the text accompanying the statistical update tables reported by the Bretton Woods institutions, the reader will find that average annual debt service of the 27 countries during 2001-2006 is expected to be 24 per cent less than debt servicing paid in 1998-1999 (IMF and IDA 2004a, p. 6). This is fully consistent with the statement in the text, which pertains to different time periods (see *ibid.*, table 10A).

requiring resumed payments including interest on the rescheduled amounts.<sup>9</sup> For legal and political reasons, some bilateral credits have not been subject to write off and are instead rescheduled, albeit over long periods. This gives cash flow relief during grace periods, although at the expense of higher obligations later.<sup>10</sup> The creditors expect that the crisis economy will have grown sufficiently by the time “later” comes so the obligations can be serviced without difficulty; but this is not the same as not having the obligations at all.

Indeed, as of the time of writing, there is concern in various quarters that HIPC debt relief is not amounting to a true exit from HIPC debt difficulties. Even within the HIPC process, donors have agreed that HIPCs could require additional relief at the point of exit beyond that formally programmed, a process called “topping up.” However, this requires additional funds from donor governments, which in turn requires a significant additional fund-raising effort on the part of the multilateral institutions, albeit a successful one in the three cases announced thus far of Ethiopia and Niger in 2004 and Burkina Faso in 2002. After exiting the HIPC process, however, no further special relief is available for these debtor governments.

As very considerable cuts in bilateral obligations are built into the HIPC Initiative, it seems that the inadequacy of overall relief can be tied to insufficient multilateral relief. While the financial situation of the African Development Bank had been seriously weakened by the amount of non-performing debt on its books, the IMF, World Bank and the other regional banks have always been in very sound financial condition. Some civil society advocates thus argue based on accounting and financial market analysis that the World Bank and IMF could absorb a

---

<sup>9</sup> I owe this point to Benu Schneider, who further points out that if arrears nevertheless do again accumulate and are subsequently rescheduled rather than forgiven, they will yet again boost debt servicing further years out.

<sup>10</sup> In seeking comparable sacrifice among the government creditors of a given debtor, the Paris Club has looked for equivalent “net present values” of the relief given, and an appropriate long-term rescheduling of future debt-servicing obligations can be made equivalent to that of a given debt write off. However, from the perspective of the debtor, they will not be equivalent (see Gunter 2003, pp. 10-11).

straightforward write-off of 100 per cent of the obligations of the HIPCs with no untoward consequences for the institutions (Drop the Debt 2002). The Fund and Bank have not accepted the argument (IMF and World Bank 2001) and the debate continues (Kapoor 2003).

### **What should the debt level be after a debt crisis workout?**

A government that is forced to default needs either temporary or permanent relief from its obligations. How does one know how much relief such a government needs to escape from its debt crisis? For a country with a “liquidity crisis”, the answer is that it needs sufficient funds to cover the obligations falling due during the period of liquidity shortfall. In the case of a “solvency crisis”, i.e., when a permanent reduction is required in debt servicing obligations (equivalent to a reduction in the net present value of the debt), the answer is more easily stated in principle than in practice.

The end-point of a work out from sovereign debt insolvency should place the government in a “sustainable” external debt situation, meaning it should be able, with appropriate economic management, to service its foreign debt as far as can be seen into the murky future without undue economic or political strain. That is increasingly taken to mean not only that a government needs to be able to meet its external obligations on a timely basis in “normal” times, but that it should also be able to withstand the likely volatility in the international economy and the uncertainties, as about natural disasters, in the domestic economy.

### ***Market test***

How would one know what the sustainable debt level is for a government? One approach has been to argue for a “market test”, applicable at least for the countries borrowing from private creditors. This says, in effect, that wisdom is embodied collectively in the decisions of the thousands of buyers and sellers of the government securities of emerging economies. Advocates

of this view say the international financial market will impose a “proper” risk premium on a country’s bonds and one may thus know the market’s view of the country’s debt sustainability by the extra interest rate the country has to pay on its bonds relative to the interest rate on what is uniformly considered the world’s most risk-free securities, those of the US Treasury.<sup>11</sup> If the country is deemed to have a dangerous level of debt, the market will “close” to the country and it will not be able to sell any bonds. In this extreme case, the risk premium is infinite. In general, the higher the risk premium, the greater is the implied probability of default and the lower is the likelihood that the country’s debt is sustainable.

Unfortunately, this approach is quite unreliable whether the security being assessed by the market is an emerging economy sovereign bond or a share of stock in a corporation. While the financial market is indeed a mechanism for efficiently aggregating the views of all its participants, it requires a leap of faith to ascribe wisdom to the result. It assumes, in particular, that the market participants are well informed and rational in their purchase and sales decisions. However, the “sell side” has an interest in slanting information about the securities it is marketing and the “buy side” has to cope with the high cost of usable information. That is, even in the case of emerging economies, there is a continuous and ever-growing stream of information that should be sorted, analysed and assessed before using it in decisions to buy, hold or sell an emerging economy government bond.<sup>12</sup>

In practice, investors tend to ignore the accumulation of warning signs in various data series on a security, whether bond or stock, until at some point they react strongly, causing large

---

<sup>11</sup> Equivalently, the country’s risk premium on international bank loans is the “spread” the government has to pay over the interest rate major banks offer each other for standard inter-bank dollar loans in London.

<sup>12</sup> This concern has led financial market professionals who advise on emerging economy securities to propose mechanisms to gather and present information in user-friendly ways and to open up better channels of communication between international investors and government borrowers (see, for example, Samuels 2002).

gyrations in the price of the security. Uncertainty about a firm's or a country's situation, as well as about what the rest of the market knows or believes about the situation, can lead investors to act like a stampeding cattle herd; e.g., they may overreact to buy or sell decisions by a respected investor who it is feared could have more information than the rest of the market. This was most prominently observed in the panic selling of local currency assets by investors in East Asian emerging economies in the late 1980s, but occurred as well in the excessively positive assessments of U.S. equity securities, notably of relatively new firms in the information and communication technology sectors in the United States before the stock-market bubble burst at the dawn of the new millennium.

### ***Macroeconomic assessment***

A different approach to assessing debt sustainability looks to macroeconomic analysis. It is based on reasoning about foreign borrowing and overall economic performance. Economists have deduced quantitative relationships between total rates of government or foreign borrowing, economic growth and other variables that can indicate when a country is in an unsustainable situation. In this context, unsustainable means the country will become insolvent; i.e., whatever the starting level of debt, borrowing at that rate given the projected rate of economic growth and other variables would cause debt-servicing obligations to grow explosively and without limit and thus eventually cause a breakdown in debt-servicing payments. The quantitative relationships for insolvency thus posit conditions under which the ratio of debt to key variables (gross domestic product (GDP), export earnings, fiscal revenues) grows over time. However, this does not take us far enough since sustainable is not simply the obverse of unsustainable. A country situation that is "not unsustainable" in the sense used above may still not be sustainable. It could very well be

vulnerable to economic shocks that would render its situation unsustainable.<sup>13</sup>

As pure theory does not yield any “laws” to say what the “sustainable” level of debt is for any country, economists turned to a more empirical approach. Researchers have looked at experiences of countries that have had and that did not have debt crises and sought to draw conclusions as to why they differed.<sup>14</sup> Researchers at IMF and World Bank have sought in the most recent such exercises for the case of low-income countries to determine criteria for debt sustainability in the form of “trigger” values of the standard debt ratios, such as the ratio of the total stock of foreign debt to export earnings or GDP, or the ratio of public debt to government revenue (IMF and IDA 2004, and Kraay and Nehru 2004). Countries with debt ratios on the safe side of the trigger values are deemed to have sustainable debt, while passing to the other side of the trigger value is meant to be a warning sign of unsustainability.

However, the research methodology of using cross-country statistical exercises to derive the triggers means that they apply to the “average” country and the “average” country does not actually exist. At best, the trigger values are crude rules of thumb, as the researchers themselves are the first to acknowledge. Also, these particular statistical exercises do not point with great confidence to a single value of a given trigger variable, but leave a great deal of uncertainty as to just where the trigger values should be placed. Even when dividing borrowing countries into different classifications to reduce their heterogeneity (low or middle-income, “strong” or “weak” policy making), the guidance from the empirical analysis leaves such a range of uncertainty that at this point it does little more than pose questions that the analyst may use in making his or her judgements.

---

<sup>13</sup> For a verbal exposition of this multiple equilibrium model, see Roubini (2001)

<sup>14</sup> For a recent review, see IMF (2003d).

### *Social and political dimensions*

There is, moreover, an important shortcoming in the macroeconomic approach to debt sustainability, namely that it misses its social and thus political dimensions. The political dimension is especially germane, as one is considering here government debt. If a large segment of a population has been too tightly squeezed in part to service an excessive level of foreign debt, it may come to support a strong government stand against the creditors and, in the extreme, debt repudiation. Argentine bondholders may have felt this was essentially what the new Argentine administration of President Néstor Kirchner was proposing in its opening debt restructuring proposal in September 2003, which, all in all, added up to a 90 per cent write down in the present value of obligations that would be paid under the proposal versus those that were due on defaulted Argentine bonds. Indeed, the Argentine population has paid dearly for the policy choices and the private and official lending to the Government that led up to the debt crisis. Argentina's chief debt negotiator summarized the years of crisis as follows,

“The lost wealth and opportunities have hit Argentines hard. In all, Argentines lost over US \$12 billion in pension savings alone; banks lost another US \$9 billion, while thousands of firms went bankrupt. Unemployment reached historical highs of above 21 per cent, similar to the Great Depression of the United States or in the aftermath of World War II in Germany. Argentina lost two thirds of its GDP in US dollar terms, becoming only a US \$100 billion economy after the peso devaluation...

“One of the shocking features of the current situation is the evident misuse of resources on an unprecedented scale. Argentina piled up massive amounts of debt, but where is the counterpart of that debt? Where is the infrastructure: schools, hospitals, roads that were built with those resources? It's simply not there... (Nielsen 2003).

There is a further political dimension to debt sustainability that arises when considering

the debt of poor countries or countries with large populations of poor people. That is, when the leaders of the world's governments adopted the Millennium Declaration in the United Nations General Assembly in 2000 (UN 2000), they pledged to achieve specific social and economic goals by 2015, such as halving the number of people living on only one dollar a day and ensuring that all boys and girls receive a full course of primary schooling.<sup>15</sup> In this, they implicitly agreed to examine the poverty impact of the debt servicing that would be paid by a government should it need to work out from under a debt crisis.

The world's governments made the implicit explicit when their heads of state and government and other senior officials adopted the Monterrey Consensus at the International Conference on Financing for Development in 2002 (UN 2002). That is, they agreed that

“Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration...Continued efforts are needed to reduce the debt burden of heavily indebted poor countries to sustainable levels” (UN 2002, paragraph 49).

This commitment notwithstanding, neither creditor governments nor the IMF, World Bank or the regional development banks have acted upon it, despite strong pledges of commitment to reaching the Millennium Development Goals (MDGs).

One approach to how they might take account of the impact of debt servicing in reaching the MDGs focuses on the impact of annual interest and principal payments on the government's budget. This approach does not ask directly how low to make the stock of debt, but rather at what level to cap debt servicing each year. Indeed, a bill that passed both Houses of the United States

---

<sup>15</sup> For the Millennium Development Goals, statistical indicators used in monitoring progress towards them and related reports, see the United Nations web page at <http://www.un.org/millenniumgoals>.

Congress in 2003 and was signed into law by President George Bush said that the Secretary of the Treasury should commence efforts to modify the HIPC Initiative, *inter alia*, so as to limit debt servicing for HIPCs to 10 per cent of current government revenues, except for countries having a “public health crisis” in which case the maximum would be set at 5 per cent. A public health crisis was defined as a rate of HIV/AIDS infection of “at least 5 per cent among women attending prenatal clinics or more than 20 per cent among individuals in groups with high-risk behaviour.”<sup>16</sup> Undoubtedly, the 5 and 10 per cent maximums set for government revenue devoted to debt servicing were somewhat arbitrary, but they indicated the political priorities of the sponsors of the legislation regarding government expenditure on social imperatives versus official debt-servicing imperatives.<sup>17</sup>

For many HIPCs, envisaged debt-servicing ceilings and similar approaches would mean reducing debt levels significantly below what is deemed “sustainable” under purely macroeconomic criteria (Greenhill and Blackmore 2002). For HIPCs, which have already seen very substantial reductions in bilateral debt, this would have to mean greater forgiveness of multilateral debt, which would not be simple to bring about under current practices, as discussed earlier.

This is not to say that even the complete write off of all the debt of poor countries, thereby reducing their debt servicing to zero, would free sufficient resources for them to meet the MDGs, let alone enjoy adequate rates of economic growth and development. The broadly accepted view is that far larger international transfers are required, with \$50 billion commonly

---

<sup>16</sup> Section 1625 (Modification of the Enhanced HIPC Initiative) of Title V (International Financial Institutions) of H.R.1298 (United States Leadership Against HIV/AIDS, Tuberculosis, and Malaria Act of 2003).

<sup>17</sup> Draft legislation was originally introduced in each House of the US Congress in 2002 by Senators Joseph Biden and Rick Santorum and Congressmen Chris Smith and John LaFalce with additional bi-partisan support. The Executive Branch of the Government interprets the adopted legislation as advisory.

proffered as a rough estimate of the required magnitude of additional annual support. It would be imperative as well to deliver those financial resources on terms that the receiving countries could absorb, which means in the form of grants whenever even highly concessional lending would raise debt ratios above the trigger values. But even though debt relief is not the full answer to the resource constraint on reaching the MDGs, civil society advocates argue that more substantial relief should contribute to the answer (Northover 2003). It is a form of assistance akin to unrestricted budget support in that it has a relatively low transaction cost compared to project aid (which is not to minimize the cost of negotiating debt reduction agreements with each creditor).

### *Limits of analysis*

By this point in the discussion it should be clear that there is no one “correct” answer to the question of what is the sustainable debt level for a country. The setting of targets, triggers or ceilings on debt indicators in general and especially in workouts from debt crises is best viewed as a heuristic device to help guide judgement on a case-by-case basis.

However, sometimes “case-by-case” is just too complex a basis for a political agreement. Then uniform rules of thumb, such as the proposed maximum debt-servicing ratios cited above in the US legislation or the targets actually used to set the end-point of debt reduction under the HIPC Initiative, are simplifications that make political agreement possible. In the case of the HIPC Initiative, the primary indicator is that the current level of debt, measured as the net present value of each HIPC’s debt servicing into the distant future, should end up no more than 150 per cent of its export earnings, averaged over the past three years (see World Bank 2003, pp. 18-24). The target may not represent what is actually needed for the country to be in a sustainable situation, but the governments and international institutions that are the overwhelming majority of HIPC creditors were able to agree to such indicators as “binding

thresholds” for relief (IMF and IDA 2004, p. 5) and commit themselves to collectively bring each HIPC to that level of the relevant indicators at the “completion point” of the HIPC process.

Nevertheless, governments, whether or not in crisis, need to make judgements about their actual debt sustainability. Official aid providers also increasingly focus on how much of their assistance to provide as loans versus grants. These judgements need to embody an assessment of the country’s economic trends relative to debt levels well into the future, as well as the government’s ability and willingness to react appropriately if confronted with an unexpected deterioration in debt-servicing capacity. Sustainability also depends on the degree to which the government can tap official or private resources on appropriate terms to meet an unforeseen squeeze on liquidity arising from economic shocks. In the end, policy makers need to reflect on their attitude towards risk, as they balance expected benefits of additional borrowing against the extra risk from carrying additional debt.

Indeed, the independent bond rating agencies — such as Moody’s Investors Service, Standard & Poor’s and Fitch Ratings — make just such assessments in assigning scores to sovereign credits. Their ratings aim precisely at judging the probability of sovereign default. Bond buyers look to the ratings by these services for guidance, and government regulators of insurance companies, pension funds and increasingly of commercial banks also rely on their judgements in classifying the riskiness of different sovereign securities held by the financial firms they oversee. This is not to say that the ratings agencies are necessarily accurate or that they perceive changes in country situations with sufficient alacrity,<sup>18</sup> but rather that they are better than any mechanical formula or benchmark.

---

<sup>18</sup> “...[T]he ratings of the credit rating agencies lag the financial condition of the enterprise or country, sometimes substantially. Any credit officer of a major financial services firm knows that, and therefore performs his own analysis” (Charles Lucas, Vice President and Director, Market Risk Management, American International Group, Inc., in Herman 1999, p. 435).

How does this help when it comes time for a country to work out from a debt crisis? Workouts are shaped in a structured set of negotiations involving different classes of creditors and the debtor government. The fact that the “proper” end point is hard to determine is an invitation to the different sides to press their respective interests. As in any negotiation, the actual outcome reflects the different degrees of power and different negotiation capacities of the various players.

### **Organizing the players for the debt workout**

A debt workout entails agreement between a debtor government and its creditors on precisely how to restructure the government’s debt-servicing obligations. The obligations are contained in the various contracts between the government and each of its creditors, which typically contain provisions for dealing with default, albeit under the laws of different States and bringing to bear different mechanisms for arriving at the new structure of obligations. By its very nature, this is a highly decentralized process and considerable importance lies in how to coordinate it for the benefit of the people in the debtor country.

### ***Paris Club reform***

In the case of government creditors, as noted earlier, for almost half a century the major countries have sought to coordinate their relief through the Paris Club. The Club operates by negotiating an Agreed Minute with the debtor country, which outlines the terms of the overall relief. The country then has to negotiate implementing agreements with each member of the Club and it is charged to seek comparable terms from non-members.

While the debtor is not well placed to ensure that its agreed Paris Club terms are applied to non-member governments, the Club members may themselves bring a measure of pressure to bear on them. However, the debtor is also charged to seek comparable terms from private

creditors and this has provoked a considerable controversy, especially in recent years among purchasers of emerging economy foreign currency bonds (see EMTA 2001). Firstly, private creditors found the operations of the Paris Club opaque and relevant information hard to obtain. If their own debt restructuring was supposed to be concordant with Paris Club decisions, the mystery of how those decisions were arrived at needed to be solved. Secondly, they felt that the major governments were seeking to shift more of the burden of crisis resolution “haircuts” toward the private creditors. This in their view was far from the “comparable treatment” the Paris Club formally espoused, which in any case was hard to define when all Paris Club debt had originally been policy-based loans in contrast to the investment motivations of private creditors.

The issue of comparable treatment has also been difficult because the private creditors and the Paris Club have very different incentives in settling with the defaulted debtor. The private creditors have strong reasons to settle with the debtor as soon as possible through a “stock-of-debt” adjustment, typically a one-time swap of a new bond for a defaulted loan or a new bond for a defaulted bond. Such an arrangement would allow the creditors to recoup as much as possible of their claims and then exit relatively quickly, which today they tend to want to do. The Paris Club, in contrast, has favoured “flow restructuring” in which debt servicing due within a specified period is rescheduled and possibly reduced, with subsequent debtor government trips to the Paris Club arranged as needed. One attraction of this approach to the government agency that originally made the non-performing loans is that it can stretch out recognizing the budgetary consequences of the losses on its credits. Perhaps as important, the Paris Club approach embodies the view that debt relief is part of a comprehensive rescue package of multilateral and bilateral support to help the country implement an IMF-supported adjustment programme. Relief is deemed warranted only if the debtor remains on track with

IMF. Repeated visits to the Club thus serve as a “short leash”, providing an incentive for continued cooperation with the Fund. Private creditors did not view themselves as having any such policy responsibility.

In fact, the Paris Club has recognized the widespread dissatisfaction in the private creditor community and has sought to respond to its critics. First, it started an Internet web page in 2001 to disseminate information and began to meet with representatives of private creditor organizations. Then in October 2003 it adopted a new “Evian Approach” to debt restructuring in response to an agreement of the finance ministers of the Group of 8 to reform the Club (Paris Club 2003). The new approach would apply to debt-crisis countries that are deemed to require a reduction in debt and not more simply a reprofiling of debt servicing (it excludes HIPC, for which the HIPC Initiative would apply). The new Approach comes part way to the “stock-of-debt” approach favoured by the private creditors, while maintaining the link of relief to performance under an IMF-supported adjustment programme.

The Evian Approach could work in stages: first, Paris Club creditors would give a “flow treatment” for one to three years, conditional on satisfactory performance under an IMF programme; second, the Club would then implement part of the country’s final debt reduction or other special “exit treatment” during a successor programme with IMF; and third, the remainder of the exit treatment would be given on the successful conclusion of the IMF programme. As of September 2004, these new arrangements have not been applied to any crisis country. There is also no indication of the extent to which they might reduce tensions with private creditors over who defines “comparable treatment” of a defaulting sovereign or precisely how to define it.

### ***Organizing the private creditors***

The private creditors are today the most challenging group to organize for debt

negotiations. In the 1980s, as earlier noted, London Clubs or Bank Advisory Committees formed to renegotiate syndicated loans in which large numbers of banks, sometimes as many as 500, would take part in a syndicate organized by a small number of lead banks. As the dominant type of international private lending to sovereigns, this provided the beginnings of a ready-made set of structures within which to renegotiate the debtor's obligations after default. There were relatively few international sovereign bonds in this period and they mostly continued to be serviced even when the government defaulted on its bank debt. However, by the late 1990s, most of the new sovereign borrowing on international financial markets was in the form of bonds. Thus, while London Clubs still function as negotiating vehicles for international bank debt, new mechanisms were required to treat defaulted bond debt.

Bank creditors of defaulting sovereigns in the 1980s were initially — like the Paris Club members — in no hurry to resolve the crises, preferring to treat them as liquidity problems for which “concerted” new lending was the appropriate response.<sup>19</sup> By the latter half of the decade, however, shareholder concerns about the financial condition of the banks pushed down the prices of their stocks enough and regulators expressed enough concern that the bank managements sought a final debt-stock adjustment through the “Brady Plan” noted earlier to clean their books of the distressed debt. The reason the banks could delay at first is that they had faced no immediate pressure to acknowledge in their accounting statements the fall in the value of their distressed loans. Bondholders inhabit a different universe: bonds trade in a global market and the practice of “marking to market” means that the institution holding the bond has to register its loss in market value the day it occurs. Unlike the bankers in the 1980s, they have no place to hide and

---

<sup>19</sup> The new lending had to be concerted because left to itself each bank would prefer that other banks take on the added risk of the new lending. Only a collective creditor negotiation could mobilize the requisite funds.

nothing is gained by delay.<sup>20</sup>

The key question is then how to arrange the one-shot workout for the bondholders. Bonds issued under English law typically require approval of 75 per cent of bondholders present at a meeting that has enough people in it to satisfy quorum requirements to change the financial terms of the bond. If the requisite majority approves a proposed amendment to the bond contract, its terms would be revised and thereby apply to all bondholders whether or not they voted for the change. However, most sovereign bonds of developing and transition economies are not issued under English law, but under New York law, which has required unanimous agreement to change any financial terms of the bond (Eichengreen 2003).<sup>21</sup>

Amending a bond contract has thus been very difficult under New York law, but it has also been unnecessary as another scheme allows the debtor government to swap the old bond for a new one with easier terms. In this case, an insolvent debtor government offers a new bond with lower face value or lower interest payments in exchange for the old bond. Or, if the government faces only a liquidity crisis, the new bond would have the same present value of its future cash flow, but backload the payment stream to give short-term cash-flow relief. The difficulty under New York law bonds has been what to do if a minority of bondholders oppose the swap and instead try to force the debtor to fully honour the bond contract through the courts. If the holdouts succeed, it would reduce the resources available to the government to honour the new

---

<sup>20</sup> There has thus been concern that, immediately following a sovereign's default, some bondholders would "race to the courthouse" to attach assets of the government to cover their claims. This had not been a concern in the era of mainly bank lending owing to the "sharing clause" in syndicated bank loans in which any creditor gaining such assets would have had to share them with the other lenders on a pro-rata basis. However, today that concern about bondholders seems overblown, despite the absence of sharing clauses in most issues, based on the Argentine case. More than two years since the default, bondholders who sought redress in the courts have yet to receive any compensation, while incurring significant legal expenses.

<sup>21</sup> The English approach is also followed in bonds issued under Luxembourg and Japanese law, while German law bonds are similar to those issued under New York law (Eichengreen 2003, p. 84). As of March 2004, about 70 per cent of the value and number of external sovereign bonds outstanding had been issued under New York or German law (IMF 2004, p. 7).

bonds. Those agreeing to the swap thus have an interest in preventing holdouts from getting full payment through the courts. The majority has to be big enough — and usually is — to accomplish this by voting to change the non-financial terms of the old bond, for which they have needed less than unanimity. Thus, although holdouts can decline to participate in a swap with “exit consents”, they end up with an asset on which it would be difficult to collect (Bucheit and Gulati 2000).

“Exit consents” have been used successfully to facilitate various recent bond exchanges, although disgruntled holdout creditors could still challenge particular terms of exit consents in the courts, charging abuse of an otherwise accepted legal mechanism (Chamberlin 2001). This is one reason that both financial market professionals and bond-issuing governments agreed in 2003 that it was time to revise the terms of New York law bonds and add “collective action clauses” (CACs) along the lines of those already in English law bonds.<sup>22</sup>

In February 2003, Mexico became the first emerging economy country to issue sovereign bonds under New York law with the new clauses. This broke the ice and the practice grew from the second quarter of 2003. From August 2003 to March 2004, 75 per cent of the value of New York law bonds of emerging economy sovereigns (70 per cent by number) contained CACs (IMF 2004 pp. 2-3). The terms of the CACs are also beginning to converge towards a standard, e.g., 75 per cent super majority required to change the financial terms of the bonds (for details, see IMF 2004).

While CACs provide ways to restructure an individual bond issue, most emerging economy sovereign borrowers have multiple issues outstanding at any one time. Argentina has

---

<sup>22</sup> In fact, more is involved in New York law bonds than shifting to a specified “super majority” to change the financial terms and changes have also been proposed in the contractual terms of English law bonds. For details of proposals from a group of 7 private financial organizations, see EMTA and others (2003), and for proposals from the governments of the countries where most international bonds are issued, see Group of 10 (2002).

“more than 150 different bonds, issued in 8 different jurisdictions and in 7 different currencies” (Neilsen, p. 2). To treat them one at a time would be extremely cumbersome and raise questions about whether bondholders at one end of the queue would get terms equivalent to those at the other end. Instead, the preferred mechanism is a bond “exchange offer” that groups multiple issues. This was the approach in the first major debt swap using exit consents to bind in the bondholders, that for Ecuador in 2000, when four “Brady bonds” (originally created in the final workout from Ecuador’s 1980s default on commercial bank debt) and two Eurobonds were converted into a 30-year bond and one with a 12 year maturity. The exchange-offer technique was also used by Uruguay in 2003 to convert 65 bonds accounting for nearly all of Uruguay’s bond debt and about half its total sovereign debt (IMF 2003c, p. 27).

In addition to adding CACs to its new bonds, Uruguay introduced an interesting feature that can facilitate any further restructuring it may need. In the current practice of exchange offers, the holders of each outstanding bond series have to approve the swap according to the terms of their own bond contracts and the law of the market in which they are issued. Uruguay’s new bonds contain an “aggregation clause” under which if a specified large majority of all bondholders taken together approve the change, then the majority of any single issue required to approve the new terms will be lowered. This will reduce the power of the holders of any one issue to stop the overall exchange when the overall majority wants it. It speaks to the particular difficulty of how to bind in recalcitrant minorities of creditors so they do not obstruct the overall restructuring or use their power to make the final accepted restructuring less advantageous to the borrower than is warranted.

It is premature to expect the Uruguay aggregation clause to become standard practice, although Uruguay has put the issue on the policy table. In practice, for aggregation clauses in

bond contracts to become meaningful, they need to be in all of a government's outstanding bonds and absent a debt-crisis exchange offer like Uruguay's it could take a decade or so to roll over all maturing bonds into new ones with aggregation clauses even after standard terms are agreed.

JPMorgan, the investment bank, suggested a different approach for overcoming the aggregation problem among bondholders. It would have a debtor in crisis quickly create an exchange offer with a small cash payment "carrot" and exit consent "stick" to turn all the holders of multiple bond issues into holders of a single temporary security called an "interim debt claim", which could be traded openly. The new security would contain CACs and specify how the holders would be represented in negotiations with the debtor. A final exchange offer into a permanent new security or set of securities would then be negotiated by the creditors committee and voted by the holders of the interim security (Bartholomew, Stern and Liuzzi 2002). No government has yet to try the scheme.

### ***The search for a comprehensive approach***

Even if all the bondholders could be aggregated into a single negotiation, and if the bank creditors were all brought under a London Club, and if all official creditors followed the Paris Club Agreed Minute, and if holders of other claims on the government, such as unpaid supplier's credits, were organized into groups, there would remain the question of how to ensure that the overall relief accorded in the end puts the debt-crisis country into a "sustainable" debt situation. Today, nothing guarantees that this happens, let alone that all the creditors are covered by or bound by the respective negotiating committees.

Traditionally, IMF represents the global interest in a sovereign debt workout, negotiating with the debtor country on the adjustment programme it needs to follow, deciding on the amount of its own lending to offer to the country and working with other creditors on the overall package

of financing-*cum*-debt relief. The Fund in this process has been criticized as too creditor-oriented, as too easy on the debtor governments, and as protecting its own interest as a creditor to the debtor country above all else. IMF is not, in any case, in a position to force its views on the other creditors or the other providers of official financing, and although the debtor government is usually in a relatively weak bargaining position, there are limits beyond which it cannot be pushed. In practice, as a result, IMF forcefully coordinates a process that iterates between what the country needs and what the creditors are willing to provide.

IMF staff proposed a dramatic departure from this standard informal approach that might have strengthened the overall coherence of debt workouts had it been accepted. However, the proposal, the Sovereign Debt Restructuring Mechanism (SDRM), would also have radically altered the legal architecture of international finance.<sup>23</sup> The private creditor community was apoplectic over the proposal, seeing it as a challenge to “creditor rights”, tilting the negotiating power towards the debtor and, more precisely, reducing creditor ability to use the threat of court action to press their interests in “market-based” negotiations with an insolvent debtor government.

The SDRM would have obviated the need to use contractual or market-based schemes or “clubs” to aggregate the different creditors into their respective creditor groups, as they would all be brought under the SDRM by a process that would supersede the terms of the individual contracts between the creditors and the sovereign debtor. Under the proposal, all the covered creditors would be grouped into relevant classes.<sup>24</sup> Each class would appoint a committee to negotiate with the debtor on its behalf and they could also coordinate across the committees. All

---

<sup>23</sup> The proposal was developed in a set of speeches by the First Deputy Managing Director, Ms. Anne Krueger, and in a series of staff reports (for a full listing, see IMF 2003).

<sup>24</sup> In the end, the Fund left open whether the Paris Club would be subsumed under the SDRM (IMF 2003a, p.4).

creditors in the covered classes would be effectively forced to participate in the decisions reached by the relevant majorities, obviating the holdout problem that has been a focus of concern in bond restructurings, as noted above.<sup>25</sup>

This “statutory approach” would have had the force of law, as it would have been adopted as an amendment to the IMF Articles of Agreement. It would have thus obligated all IMF members even if they had not approved the amendment themselves. It would also have created an independent quasi-judicial mechanism for registering creditor claims and panels of “judges” who would resolve disputes between the involved parties to a restructuring. IMF would have continued to monitor the overall debt-restructuring process and give advice on the coherence of the overall package. However, the debt workout negotiations themselves would always be directly between the debtor and its various creditor groups. Also, while IMF would have considerable influence over the debtor’s policies during the workout period through standard negotiated adjustment programmes, it would still not have the formal power to enforce agreed policy implementation by sovereign governments (a point of concern to creditors, who would have been legally bound by the restructuring agreement).

Given the radical nature of the SDRM proposal, not to mention that some of its elements required further development so as to address legitimate concerns of some of the relevant parties, a number of observers cautioned against premature closure around any specific legal text (e.g., Herman 2003, Roubini and Setser 2003). However, the ministerial-level International Monetary and Financial Committee requested that the IMF staff make just such a specific proposal, which it did in the spring of 2003, including a draft of the amendment to the Articles of Agreement.

---

<sup>25</sup> In addition, to stop any “race to the courthouse” (see footnote 20), a temporary stay on litigation was considered in early discussions of the SDRM, although it was dropped in the end for a variant on the “sharing clause” (see IMF 2003a, pp. 8-13).

That was rejected and all momentum behind the proposal died after that.

Partly as an alternative to the SDRM proposal, a group of private financial organizations had offered another approach that is voluntary at its core, but holds out a measure of practical promise. This proposal is to design a “code of conduct” for how the debtor and its creditors should act to resolve a sovereign debt crisis (EMTA and others 2003). While not binding, if it gained wide endorsement such a code could reduce uncertainty about how a debt restructuring would proceed, raise confidence that the procedures would be transparent and fair in the treatment of different creditor groups, and pledge that there would be no undue delays by any party or worsening of the situation, as through unwarranted withdrawal of trade or inter-bank credit lines. The Banque de France circulated a subsequent draft code, known as the “Trichet proposal” after Jean-Claude Trichet, the bank’s president at the time (Banque de France 2003; Couillault and Weber 2003). The French central bank and the financial industry’s Institute of International Finance, and more recently the Group of 20 finance ministers, have organized discussions of the code between selected individuals from official and private sectors (IMF 2004, pp. 12-13). While such discussions are an important first step, it is necessary to broaden the discussion to include all relevant stakeholders. Especially as it is to be voluntary, a draft code will need to gain wide ownership if it is to win convincing acceptance.

While as might be expected, the financial-sector code is more pro-investor and the Trichet proposal more balanced (Berensmann 2003, pp. 9-13), the Trichet proposal is also distinct in offering to make independent mediation available as a potential tool to help the various parties come to a coherent and appropriate conclusion. This idea was picked up by IMF in its 2003 post-SDRM review of sovereign debt restructuring policy (IMF 2003c, pp. 20-21), drawing in particular on a proposal that Richard Gitlin, a prominent US attorney, had presented

to the International Conference on Financing for Development in Monterrey, Mexico in March 2002 and later at IMF (Gitlin 2002).

Mr. Gitlin proposed establishing an international debt mediation service, with a standing panel of mediators available to be tapped as needed for individual cases. The mediation service would be part of a “sovereign debt restructuring forum” that would also develop principles for restructuring debt (in essence, a code of conduct) and offer private adjudication of disputes. The restructuring forum would be complemented by a parallel forum that would seek to enhance sovereign debt as an asset class for investors through improving the terms of debt instruments, improving the flow of information to the market and promoting “best practices.” In short, the “Sovereign Debt Forum”, as the overall initiative would be called, would aim to earn the confidence of both private creditors and governments that issue sovereign bonds.

In fact, both mediation and arbitration had been proposed earlier, albeit outside the financial market community. In particular, the Secretary-General of the United Nations in his main report to the Preparatory Committee for the Financing for Development Conference in 2000 proposed that a “mediation-type mechanism” deserved “particular attention” as an additional voluntary option for restructuring debt owed to private and bilateral official creditors (UN 2000a, p. 46). His proposal was to add to the menu of available practices “a mechanism for the simultaneous, fair and full treatment of all of a country’s foreign debt obligations, along with the provision of required new funds by the international community and other creditors.” The mechanism would be available to countries already cooperating with IMF and other international financial institutions and would seek to facilitate bringing together “committees representing bank creditors, bondholders, the Paris Club and other bilateral official creditors, as appropriate, plus the debtor government.” He argued that an independent mediator, assisted by IMF and other

experts, could facilitate arriving at an agreed and adequate financial package that ensured fairness, reduced financial uncertainties quickly and lowered the cost to creditors as well as to the debtor of arriving at a final restructuring agreement (ibid).

Arbitration, on the other hand, was at the core of a proposal developed by several civil society organizations and called variously the “Jubilee Framework for International Insolvency” (Pettifor 2002) and a “Fair and Transparent Arbitration Process” (Fritz and Hersel 2002). One key aspect of the proposal is that a balanced panel of independent arbitrators would make the decisions on the overall size and allocation of the “haircut” needed to return the debtor government to a sustainable situation, rather than have it result from a negotiation of unequal parties. In this regard, IMF would play a less central role. A second key aspect is that it would open the debt restructuring process to greater participation by domestic economic and social stakeholders in the insolvent economy. That is, the arbitration panel would gather information from all relevant stakeholders, including civil society, and lift debt restructuring out from behind closed-door negotiations between the finance ministry of the indebted country and the foreign creditors. In particular, in making their judgements the arbitrators could take account of the social as well as financial aspects of debt sustainability, as discussed earlier in this paper.

Arbitration is not the usual method for restructuring sovereign debt, although it has been a standard dispute-settlement mechanism in international commercial, inter-state and enterprise-state disputes (Fritz and Hersel 2002, pp. 28-33). Both the option to resort to arbitration and the rules under which it would operate are usually specified in individual contracts. For something like this to be built into standard clauses in sovereign bond contracts would be a major

innovation.<sup>26</sup> Despite the fact that the proposed mechanism seems unachievable at this time, the proposal raises important issues about what should be considered in a fair and transparent process and reminds us of the need to take a broad view of debt sustainability in the final debt restructuring package.

## **Conclusion**

Sovereign debt crises are and will continue to be difficult policy problems for the “international community”. The fundamental reason is the sovereignty of the borrower. Proponents of bankruptcy regimes for governments are arguing by metaphor. No governmental agency or municipality that can enter a formal bankruptcy regime under existing law is itself sovereign. Absent a world government or treaties in which governments agree to waive their sovereignty in more than a very limited sense, resolving sovereign debt crises will require informal cooperative international regimes. This is what we have and the more promising proposals for reform continue in this tradition.

Successful reform is essential. Economic crises in developing economies have been and can again become global threats. One way discussed in this paper is through the globalization of financial markets, which makes financial instability in one country, even a relatively small one, into a potential crisis for the rest of the international system. But debt crises also occur in low-income countries without access to financial markets, when they result from bilateral and multilateral lending gone awry. In resolving both types of debt crises, people in the indebted countries pay a disproportionate price. The social and political stresses that accompany these

---

<sup>26</sup> This does not mean it would be impossible. Arbitration is already available to corporate bondholders under the laws of the State of Delaware in the United States, wherein dissenting minority creditors have “rights of appraisal” that can trigger arbitration or appointment of a “special master” to resolve the dispute. Such an approach could equally be written into sovereign bond contracts, following appropriate statutory action, in particular, in New York and London, where most sovereign bonds are issued (I owe this point to Frank Fernandez).

crises are well known. This does nothing to ameliorate the heightened sense of personal insecurity in those countries and — owing to the wave of international terrorism — around the world. Terrorism has many causes, but poverty and humiliation are surely among them and protracted economic crises feed such conditions. Out of these concerns, as well as the basic humanitarian imperatives that move voters around the world, finding better ways to resolve sovereign debt crises necessarily remains on the international political agenda.

## References

- Banque de France. 2003. “Towards a Code of Good Conduct on Sovereign Debt Re-Negotiation.” Issues paper prepared by Banque de France staff (“Trichet proposal”). January.
- Bartholomew, Ed, Ernest Stern and Angela Liuzzi. 2002. “Two-step Sovereign Debt Restructuring: A Market-based Approach in a World without International Bankruptcy Law.” JP Morgan [[http://emcreditors.com/pdf/n\\_Two-step%2001.28.02.PDF](http://emcreditors.com/pdf/n_Two-step%2001.28.02.PDF)].
- Berensmann, Kathrin. 2003. “Involving Private Creditors in the Prevention and Resolution of International Debt Crises.” Reports and Working Papers 8/2003. German Development Institute, Bonn.
- Buchheit, Lee C. and G. Mitu Gulati. 2000. “Exit Consents in Sovereign Bond Exchanges.” *UCLA Law Review* 48: 59-84.
- Chamberlin, Michael. 2001. “At the Frontier of Exit Consents.” Remarks at the Bear Stearns and EMCA Sovereign Creditors Rights Conference, 8 November 2001. *Journal of Emerging Markets* 7: 50-52.
- Cohen, Daniel, Michèle Phamtan, Cristina Rampulla and Charles Vellutini. 2004. *Beyond the HIPC Initiative*. Report to the European Commission by Investment Development Consultancy, France [[http://europa.eu.int/comm/development/body/theme/hipc/docs/Beyond\\_HIPC\\_en.pdf](http://europa.eu.int/comm/development/body/theme/hipc/docs/Beyond_HIPC_en.pdf)].
- Couillault, Bertrand and Pierre-François Weber. 2003. “Towards a Voluntary Code of Good Conduct for Sovereign Debt Restructuring.” Banque de France. *Financial Stability Review* No. 2: 154-162
- Drop the Debt. 2001. “Reality Check: The Need for Deeper Debt Cancellation and the Fight Against HIV/AIDS, Incorporating Independent Studies by Accountants Chantrey Vellacott DFK and Subhrendu Chatterji.” London [<http://www.dropthedebt.org/reports/realitycheck>].
- Eichengreen, Barry. 2003. “Restructuring Sovereign Debt.” *Journal of Economic Perspectives* 17: 75-98.
- EMTA (Trade Association for the Emerging Markets). 2001. “Burden-Sharing in 2001: Now is

- the Time to Reform the Paris Club.” Policy Paper of EMTA [<http://www.emta.org/emarkets/burden5.pdf>].
- \_\_\_\_\_. 2003. “Marketable Bonds Package” [[http://www.emta.org/ndevelop/Final\\_merged.pdf](http://www.emta.org/ndevelop/Final_merged.pdf)].
- Fritz, Thomas and Philipp Hersel. 2002. *Fair and Transparent Arbitration Processes: A New Road to Resolve Debt Crises*. Berlin: Berliner Landesarbeitsgemeinschaft Umwelt und Entwicklung (BLUE 21) and Aachen: Bischöfliches Hilfswerk MISEREOR.
- Gitlin, Richard A. 2002. “A Proposal: Sovereign Debt Forum, March 19, 2002.” Bingham Dana LLP, New York. Handout at oral presentation at International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002.
- Greenhill, Romilly and Sasha Blackmore. 2002. *Relief Works: African Proposals for Debt Cancellation — And Why Debt Relief Works*. London: Jubilee Research at the New Economics Foundation.
- Group of Ten. 2002. “Report of the G-10 Working Group on Contractual Clauses” [<http://www.bis.org/publ/gten08.htm>]
- Gunter, Bernhard G. 2003. “Achieving Long-term Debt Sustainability in all Heavily Indebted Poor Countries (HIPCs).” Paper prepared for the XVI Technical Group Meeting of the Group of 24, Trinidad and Tobago, 13-14 February 2003 [<http://www.g24.org/guntetgm.pdf>].
- Herman, Barry, ed. 1999. *Global Financial Turmoil and Reform: A United Nations Perspective*. Tokyo: United Nations University Press.
- \_\_\_\_\_. 2003. “Mechanisms for Dialogue and Debt-Crisis Workout That Can Strengthen Sovereign Lending to Developing Countries.” In Ariel Buira, ed., *Challenges to the World Bank and IMF: Developing Country Perspectives*. London: Anthem Press.
- \_\_\_\_\_. 2003a. “Asuntos Inconclusos en el Diálogo Internacional sobre la Deuda.” *Revista de la CEPAL* No. 81: 65-79.
- IMF (International Monetary Fund). 2003. “Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet” [<http://www.imf.org/external/np/exr/facts/sdrm.htm>].
- \_\_\_\_\_. 2003a. “Proposed Features of a Sovereign Debt Restructuring Mechanism” [<http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>].
- \_\_\_\_\_. 2003b. “Sustainability Assessments—Review of Application and Methodological Refinements” [<http://www.imf.org/external/np/pdr/sustain/2003/061003.htm>].
- \_\_\_\_\_. 2003c. “Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework” [<http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf>].
- \_\_\_\_\_. 2003d. “Public Debt in Emerging Markets: Is It Too High?” In *World Economic Outlook, September 2003*. Washington, D. C. : IMF.
- \_\_\_\_\_. 2004. “Progress Report to the International Monetary and Financial Committee on Crisis Resolution” [<http://www.imf.org/external/np/pdr/cr/2004/eng/042004.pdf>].
- IMF and IDA (International Development Association). 2004. “Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications”

- [<http://www.imf.org/external/np/pdr/sustain/2004/020304.htm>].
- \_\_\_\_\_. 2004a. “Heavily Indebted Poor Countries (HIPC) Initiative — Statistical Update” [[http://www.worldbank.org/hipc/Statistical\\_Update\\_March\\_2004.pdf](http://www.worldbank.org/hipc/Statistical_Update_March_2004.pdf)].
- IMF and World Bank. 2001. “100 Percent Debt Cancellation? A Response from the IMF and World Bank.” Issues Brief [<http://www.imf.org/external/np/exr/ib/2001/071001.htm>].
- Kapoor, Sony. 2003. “Can the World Bank and IMF Cancel 100% of Poor Country Debts?” Jubilee Research at the New Economics Foundation, London [<http://www.jubileeplus.org/media/230903debtCancellation.htm>].
- Kraay, Aart and Vikram Nehru. 2004. “When is Debt Sustainable?” Policy Research Working Paper No. 3200. World Bank [[http://econ.worldbank.org/files/32872\\_wps3200.pdf](http://econ.worldbank.org/files/32872_wps3200.pdf)].
- Neilsen, Guillermo. 2003. Keynote Address. EMTA Annual Meeting, New York, 4 December 2003 [<http://www.argentinedebtinfo.gov.ar/documentos/emta-gn-4-12-2003-english.pdf>].
- Northover, Henry. 2003. “An Alternative Approach to Debt Cancellation and New Borrowing for Africa.” Paper presented at Republic of Senegal and UN Economic Commission for Africa Expert Group Meeting on “Solving Africa’s External Debt Problem to Finance Development”, 17-18 November, Dakar [<http://www.uneca.org/debtforum/>].
- Paris Club. 2003. “Evian Approach.” [<http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B06WP14>].
- Pettifor, Ann. 2002. *Chapter 9/11? Resolving International Debt Crises—the Jubilee Framework for International Insolvency*. London: Jubilee Research and New Economics Foundation.
- Roubini, Nouriel. 2001. “Debt Sustainability: How to Assess Whether a Country is Insolvent.” Unpublished paper. Stern School of Business, New York University [<http://www.stern.nyu.edu/globalmacro/debtsustainability.pdf>].
- \_\_\_\_\_ and Brad Setser. 2003. “Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform.” Paper prepared for Institute for International Economics and Institut Français des Relations Internationales Conference on Improving the Sovereign Debt Restructuring Process, Paris, 9 March 2003 [<http://www.iie.com/publications/papers/roubini-setser0303.pdf>].
- Rude, Christopher. 1999. “The 1997-1998 East Asian Financial Crisis: A New York Market-Informed View.” In Herman 1999, pp. 369-403.
- Samuels, Barbara. 2002. “Strengthening Information and Analysis in the Global Financial System: A Concrete Set of Proposals.” Discussion Paper No. 23. United Nations, Department of Economic and Social Affairs [<http://www.un.org/esa/esa02dp23.pdf>].
- Sharma, Krishnan. 1999. “Understanding the Dynamics Behind Excess Capital Inflows and Excess Capital Outflows in East Asia.” In Herman, 1999, pp. 405-430.
- UN (United Nations). 2000. United Nations Millennium Declaration. General Assembly Resolution 55/2.
- \_\_\_\_\_. 2000a. “Report of the Secretary-General to the Preparatory Committee for the High-Level International Intergovernmental Event on Financing for Development” (A/AC.257/12).

- \_\_\_\_\_. 2002. *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002*. New York: United Nations publication.
- \_\_\_\_\_. 2003. *World Economic and Social Survey, 2003*. New York: United Nations publication.
- \_\_\_\_\_. 2003a. "Implementation of and Follow-up to Commitments and Agreements Made at the International Conference on Financing for Development." Report of the Secretary-General (A/58/216).
- World Bank. 2003. *The Heavily Indebted Poor Countries (HIPC) Debt Initiative: An OED Review* (Report No. 25160). Washington, D.C.: World Bank.