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STRENGTHENING SOVEREIGN LENDING THROUGH MECHANISMS FOR DIALOGUE AND DEBT-CRISIS WORKOUT: ISSUES AND PROPOSALS

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Abstract

A positive future for foreign private lending to developing countries requires reducing perceived risk through mechanisms for more permanent debtor-creditor "conversation" and an accepted and effective "bankruptcy" approach to orderly workouts from unavoidable sovereign defaults. Developing countries fear that current reform proposals, particularly the Sovereign Debt Restructuring Mechanism of the International Monetary Fund, would increase uncertainty and borrowing costs, and certain revisions are suggested here. Most importantly, however, premature closure around any controversial proposal could rob the international system of measures for increasing investor and citizen confidence. Further consideration of the matter in all relevant forums is an urgent priority.

Introduction: why this, why now?

Governments and their multilateral financial institutions enter into the business of lending to developing countries for policy reasons. The private sector does it for profit. Increasingly, people in international financial circles are asking what is the future of private lending to developing countries, and the answer is coming back that, while the earnings have been good overall, the risks were much higher than expected. In the current era, international investors broadly consider themselves exposed to more risk than perceived in the 1990s, owing to recent stock market crashes and the many prominent failures in corporate governance, let

[1] Contact: herman@un.org. This paper has benefited from discussions over the last few years, many of them off the record, with a number of individuals from the private and official sectors. To protect their innocence, I thank them without naming them. I will say that the Staff of IMF involved in developing the Fund's debt restructuring proposal have been very open in discussions with me and I believe a host of others. I appreciate as well learning from Jürgen Kaiser and Kunibert Raffer. I thank Ariel Buira, Sergei Gorbunov, Cristián Ossa and Jernej Sekolec for reading and commenting on an earlier draft. Views expressed are those of the author and not necessarily of the United Nations.

alone the current fears of war and uncertain world economic growth. Institutional and individual investors are thus asking whether they want to add more "high-risk" emerging market "paper" to their portfolios. Even where the answer is yes, they ask how much additional yield is needed to compensate for the perceived higher risk.

In fact, there is such weakness in net capital inflows to developing countries that when they are coupled with the net payment of interest and profit and the substantial accumulation of reserves by some of the countries, the developing countries as a whole are seen to have been paying more of their gross domestic product (GDP) abroad for finance-related activities than they take in; i.e., they have been making a net foreign transfer of financial resources, which in 2002, was estimated at about 1.5 per cent of their combined GDP.[2] "Negative transfers" have been occurring annually since the onset of the Asian financial crisis, and there is little in the outlook for the near future, at least, to suggest any return soon to a "normal" overall positive net transfer.

The views of the Institute of International Finance are indicative in this regard. It regularly monitors a group of 29 developing countries and countries with economies in transition for its international bank members. For 2003, it forecasts a modest increase in net capital flows to its sample of emerging market countries, although this is expected to result from the end of private capital outflows rather than an increase in inflows. It sees a "structural" problem holding back private creditors even after the cyclical situation improves. It sees a

> "gradual loss of investor appetite for emerging markets as an asset class caused by a series of financial crises and consequent huge investor losses. The universe of dedicated emerging market investors has dwindled and crossover investors have become more cautious. [Regarding bond investors per se,] recent official proposals for a formal sovereign debt restructuring mechanism, which are viewed in some quarters as increasing the likelihood of future debt restructurings, have also generated more uncertainty."[3]

The solution to the limited appetite for lending to developing countries is to reduce the perceived risk. This might be done with guarantees by rich countries or the multilateral institutions, but there is little interest in this in the donor community. More generally and despite reason to be cynical about what is feasible owing to the repeated cycles of lending boom and debt crisis over the past 25 years, lending to sovereigns has to come to be perceived as less risky. Although there have been important improvements in macroeconomic policy management in many countries, some countries still require better management of their economy. But even strongly managed economies are at risk in a volatile and uncertain international economic environment. Moreover, instead of a slowly growing world economy with weak commodity prices in which governments of major economies defensively reach for new trade protection, an enabling global environment of dynamic and sustained economic growth is needed.

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[2] Stated equivalently, the developing countries as a whole had a surplus in their balance of trade in goods and services of about 1.5 per cent of their combined GDP, which provided the financial resources to make the net transfer (see United Nations, *World Economic Situation and Prospects, 2003*, New York, 2003, p. 22.)

[3] Institute of International Finance, *Capital Flows to Emerging Market Economies*, 16 January 2003, pp. 1 and 14.

In addition, however, an increasing number of policy makers have concluded that reducing the risk of losses from lending to developing countries also requires a more explicit and systematic approach to dialogue between borrowing governments and creditors, on the one hand, and more effective ways to deal with sovereign default when it occurs, on the other hand. Partly this is because the composition of the creditors has changed and thus creditor information and communication needs have changed, as have the needs of governments for assistance in organizing workouts when debt crises erupt.

An additional factor driving the new thinking about sovereign debt is that the governments of the major industrialized countries no longer want to provide massive loans — bilaterally or through the multilateral financial institutions — to stave off debtor country defaults as were provided in the 1990s. Political opposition in major industrialized countries to additional "bailouts" is understandable, as they provide opportunities for private creditors to rescue themselves from countries receiving such loans. Opponents see the bailouts as having substituted public debt for private debt, and in certain cases as only postponing default. Although the official creditors have not lost any resources from private-creditor/debtor-country bailouts, as all such loans have been repaid with interest, there is a legitimate question of whether bailouts are an appropriate use of "taxpayer money". The answer is that in cases of liquidity crisis, it is definitely a warranted use of official resources, under appropriate safeguards. Indeed, helping countries through liquidity crises is a major reason the International Monetary Fund (IMF) exists.[4] Admittedly, however, it is often difficult to distinguish liquidity crises from solvency problems, where large official lending would not be warranted, as discussed below.

In fact, the major creditor governments have applied their "no further bailouts" policy inconsistently, leaving the private creditors confused as to what would actually happen in a new sovereign debt crisis.[5] Even so, it seems a fair assumption that aside from debtor countries that are important to the major industrialized countries for systemic or political reasons, and then even without certainty, the "no further bailouts" policy would prevail. Thus, a mechanism to more effectively handle the consequences of "no bailout" — namely, default — takes on a high priority.

In the past, although sovereign defaults happened, official and private creditors eschewed formal mechanisms for dealing with them. The Paris Club of bilateral official creditors is an informal arrangement — at best, a cartel with a conscience — with procedures that private observers find opaque and presumptuous.[6] It also has no way to "bind in" bilateral official

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[4] IMF is currently elaborating criteria for conditions and degree of access to IMF resources in such crises (see IMF, "Report of the Managing Director to the International Monetary and Financial Committee on the IMF in a Process of Change," 25 September 2002, paras. 39-44).

[5] As one journalist cryptically observed, "The IMF may need to enrol in a 12-step programme. Despite its pledge to limit bailouts, the supranational agency spent more money on large rescue packages [in 2002] than it did at the height of the Asian financial crisis in 1997" (*Institutional Investor*, January 2003, p. 50).

[6] See Brian Caplen, "Paris Club comes under attack," *Euromoney*, September 2000, pp. 56-61 (the editorial for that issue of *Euromoney* was "Paris Club: reform or die" [p. 7]) and "Burden-sharing in 2001: Now is the time to reform the Paris Club," Policy Paper of EMTA (Trade Association for the Emerging Markets), 13 February 2001, at www.emta.org). Although there have been certain improvements since these commentaries appeared, the private

creditors that are not Paris Club members, other than through moral suasion. London Club or Bank Advisory Committees for restructuring international bank loans are also informal arrangements, but they are less central than in the 1980s when bank lending dominated private sector financing. Bondholders, a globally more diffused population, seem to need more formal structures for renegotiation.[7]

Currently, many in the financial markets and debtor-country governments argue against the need to go very far in the direction of formal processes, certainly not as far as an international sovereign bankruptcy regime. The creditors seem to prefer retaining their full contractual rights to pursue uncertain legal remedies against a defaulting sovereign, rather than risk weakening them to develop more assured if collaborative mechanisms to contain their losses under a default settlement. Debtor country governments are hardly in a position to argue with them. They can only insist that they have absolutely no intention ever to default. It is not that either group is necessarily right, but neither one is ready for big changes. All that is sure at this moment is that the current situation leaves developing country governments that borrow abroad, especially those that issue bonds, in a highly uncertain and thus unsatisfactory situation.

In what follows, we first situate sovereign default as the culmination of an economic and financial deterioration that might have been stopped at various points but is not and we ask why? This points to the need for mechanisms that create regular opportunities for frank conversations between the government and its creditors, beginning before the crisis threatens. Effective and fair negotiation processes are nevertheless needed to handle the unprevented events of sovereign default. The Sovereign Debt Restructuring Mechanism (SDRM) proposed by IMF has become the obvious starting point for further discussions of such processes. However, significant revisions in its design seem warranted and some are suggested here, affecting both how the mechanism would work in a defaulting country and its international implementation.

Debt dynamics and the timing of policy intervention

Not all external debt crises of developing countries entail government default, but when governments suspend debt servicing it is usually as part of an external debt crisis of the economy as a whole. The distinction between sovereign and macroeconomic debt crises is important to keep in mind at the outset, because none of the proposed policy mechanisms to restructure the debt of sovereigns are themselves complete mechanisms for correcting external debt problems.

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sector seems to remain concerned about a central complaint in the EMTA paper regarding lack of "comparable treatment" of official and private creditors by the Paris Club.

[7] That is, major bondholders do not have the same influence over their peers as major bank creditors. Instead, legal devices that can operate in the absence of international bankruptcy arrangements have been tried, such as adopting the "exit consent" strategy from corporate bond restructuring (New York law requires full consensus to change the financial terms of a bond, but non-financial terms can be changed on a majority vote of bondholders; the sovereign issuer thus offers its bondholders a package deal to swap a new bond with different financial terms for the old bond and to change the non-financial terms of the old bond so bondholders not accepting the exchange offer end up with an inferior security). When this was used in Ecuador's case in 2000, it was said to have infuriated many market participants (see Felix Salmon, "The buy side starts to bite back", *Euromoney,* April 2001, pp. 46-61).

There almost always has to be a macroeconomic adjustment dimension, which itself shapes how much debt the government will be able to carry some years down the road. There are also various points in the genesis of a debt crisis at which policy change can alter the outcome for the country and for its creditors. In too many cases, the effective intervention does not come before the economy is in "critical condition", despite international policy makers having advocated early action for decades. Somehow, the mechanisms or incentives for early policy correction have been weak or missing.

A debt crisis, whether sovereign or private, erupts when the borrower can no longer mobilize external credit from any source but still needs to borrow, even if only just to stay current on debt servicing. There is a dynamic that typically leads to this point, during which the rate of debt build-up can surge. That is, debtors typically seek to postpone the day of reckoning as long as possible, while their credibility erodes, perceived extra risk adds to interest rates, and expensive new loans mainly serve to roll over principal falling due and capitalize increasingly unpayable interest obligations. The dynamic may be set off by a shock to the enterprise or government to which management or policy makers respond by seeking new loans. If the borrower has a good "name", it may easily mobilize new resources from the financial markets. Further down the road — or initially if it is less well known — it may rely more on good relationships with its bankers (for the governments of poor countries, these "bankers" are official institutions from the start). If the management of the entity is skilled or lucky, its response to the shock will be effective and no crisis ensues; otherwise not, sometimes speeded by additional adverse shocks.

When the deteriorating dynamic applies to the government or a large number of private institutions, it turns at some point into a macroeconomic problem and a capital-account crisis, especially when the accelerating debt build up directly involves external borrowing. That is, as the "national balance sheet" *vis-à-vis* the external world deteriorates, the probability grows of an exchange-rate crisis and then capital flight enters the picture. If the government or central bank seeks to borrow foreign exchange to defend the currency, the risk of sharp devaluation increases until it becomes inevitable. Creditors in the international financial markets will have been willing participants in this game, trading ever-higher interest charges for the greater risk perceived, until they suddenly stop, more or less simultaneously, as would a herd of cattle.

The onset of a sovereign debt crisis may be postponed if bilateral or multilateral lenders respond to the sovereign's liquidity crisis with their own new loans. As witnessed by the 1990s bailouts, this can entail large foreign official infusions, offered on the argument that it gives the country time to take corrective measures to stem the need for borrowing and that the country is not yet insolvent. The worry, of course, is that the funds also give the authorities an option for delay and give the wealthy and financial investors additional opportunities to move funds out of the country and take speculative positions against the local currency. The latter option is the road to insolvency and so, disappointed with the results of some of the large rescue programmes,

bailouts have increasingly fallen out of favour in key policy circles.[8] In any event, the growth of debt through new official lending may continue until a point is reached at which even these lenders refuse to supply more funds. At this point if not before, the government has to suspend servicing of at least some of its debt and the sovereign debt crisis is on.

The country's difficulty will have first been perceived as a liquidity crisis, which is why official loans are forthcoming when private ones are no longer available. However, as loans to cover debt-servicing pile up on top of one another, the debtor comes to be seen as insolvent, whether or not it was actually so at the start of the borrowing surge. By definition,[9] there is no point even for multilateral institutions to lend to an insolvent debtor.[10]

It is rarely clear at the moment of the suspension of debt servicing, that the country is actually insolvent. For example, in debt crises associated with current-account problems, the government may have delayed adjustment measures and seen the economy sink into a deep recession, burdened by an overvalued exchange rate; yet, the economy might be able to quickly increase production of tradable goods and services in response to devaluation and a reduction of domestic interest rates that had been raised to defend the old exchange rate. Such a growth-inducing adjustment would raise the debt-servicing capacity of the country from what it might be judged at the moment of suspension of debt servicing. In contrast, if adjustment policies further contract the economy, so as to balance expenditure with production at a low level, the likelihood of insolvency is greater. Also, if adjustment policies are delayed long enough, idle productive capacity will turn into unusable capacity. Physical capital is a wasting asset, as is the intangible capital of functioning enterprises and employed labour, when forced to be idle. Thus, the supply response will be weakened if the recovery of demand does not begin for a period of time. As a consequence, the maximum sustainable rate of economic growth will be lower than it would otherwise have been, also increasing the likelihood that the country and its government will be insolvent.

When large-scale capital flight becomes an aspect of the crisis, the last step before default might be an outright financial panic, which only a "circuit breaker" can stem, such as a full closure of the foreign exchange market for a short period, followed by reopening with new or tightened capital controls, especially on short-term financial movements, coupled with a lower or floating exchange rate. It is the nature of panics that they can do tremendous damage if left to run their course and so the situation of the country and the prospects for recovery of its debt-

[8] It should be emphasized that some of the bailouts, notably the first one, which was for Mexico in 1995, are widely judged to have been a success by international observers, although the Mexican people who absorbed the costs of the bankruptcy of the domestic banking system would probably not agree (a point emphasized by Ariel Buira).

[9] Sovereign insolvency is taken here to mean the country has no realistic prospect of being able to fully service the government's external obligations without an unacceptable reduction in living standards or increases in poverty and perhaps not even under those conditions. Insolvency requires a long-run reduction in debt servicing and thus in the present value of the claims of at least some of the creditors of the government.

[10] Multilateral institutions should not abandon such countries at this point, but they should limit their financial transactions to offers of grant assistance and relief from the servicing of their own obligations (e.g., rolling over maturing debt). Indeed, additional multilateral lending to an insolvent debtor government is effectively a grant paid for by other creditors, as it will force an equivalent loss in the value of the claims on other creditors of the government when the debt is finally restructured, owing to the preferred creditor status of the multilateral.

servicing capacity may be enhanced by the capital controls intervention. Putatively "market-friendly" governments that manage their exchange rate but eschew exchange controls may suffer very large capital outflows stemming from a loss of confidence, pushing their country into insolvency.

If the sources of current-account and capital-account crises that lead to sovereign default are addressed early, the authorities have a better chance of adopting policies that strengthen the economy and its debt-servicing capacity, and thus the country may not become insolvent. In such a situation, a necessary suspension of debt servicing might be ended with a "reprofiling" of debt-servicing obligations, i.e., a rescheduling of debt-servicing payments to banks and bilateral official creditors, and swaps into new securities for bondholders so as to postpone principal payments and partly capitalize interest, without reducing the present value of the debt. If the counter-crisis policies do not foster economic growth or if the international economic environment produces a sequence of shocks, or if political inability to take proper action allows the situation to continue deteriorating, a true insolvency may result that requires an outright reduction of the present value of the debt to resolve the country's situation.

This discussion points to a conclusion that is hardly revolutionary: early intervention is always better and the intervention should aim at quickly restoring economic growth. In fact, this advice is typically given after being strengthened with the benefit of hindsight. Seen from the middle of an evolving situation, there is usually considerable uncertainty about how much longer the adverse conditions will last or whether they will self-correct. Indeed, neither the creditors nor government policy makers seem able to form accurate judgements of the risk of default, owing either to lags in collecting and reporting various types of information, or to the natural and understandably selective perception of policy makers and investors.[11] Also, creditors and the debtor do not know each other's intentions.

Any significant policy change is politically if not economically disruptive for the authorities, and the "herd instinct" among investors puts a premium on each particular investor not being the "first mover". Thus, even in a deteriorating situation, there is pressure on both sides to maintain the current stance and gather more information as time passes. What looks like "inertia" after the fact may instead appear as a "steady hand on the tiller in a stormy sea" in the period leading up to the crisis. This is an inherent information problem and it is costly.

The value of a continuous conversation mechanism

A major theme of the international strategy for crisis prevention in developing countries since the mid-1990s has been to increase the information in the hands of international creditors

[11] An observation frequently made in 1998 was that the dangerous situation before crisis erupted in several East Asian economies was visible in publicly available data (as from the Bank for International Settlements), had anyone only cared to look. Similarly, although Mexico did not publish official reserves data on a high-frequency basis before its 1995 crisis, it did regularly publish the central bank balance sheet, from which the reserve position could be inferred and was in the local press (an observation supplied by Ariel Buira).

and government policy makers. The focus has been above all on quick, public release of standardized information and encouraging official commitment to operate various functions of government according to a set of international standards and codes of appropriate behaviour. While this is undoubtedly beneficial, when the IMF opened a channel for interaction with the international financial industry, the first matter chosen for joint analysis reflected a different approach, namely, how to facilitate "investor relations programmes", which are forums for individual government discussion with its private creditors and investors.[12]

Major international banks and investment houses, ratings agencies and other industry specialist firms have their own private access to senior officials of sovereign borrowers, which they use to gather relevant information. But such information, or the most valuable part of it, is usually confidential for political reasons, which suits the private interlocutors, as it is also a potential source of income to the firms receiving it.[13] Thus, an independent and cost-effective mechanism for carrying out such conversations with the larger investing community on a regular basis, as well as on the initiative of either debtor or creditors, would add an important instrument for reducing investor and government uncertainty and thus insecurity. Such communications can be especially important when macroeconomic and debt difficulties emerge, and creditor concerns begin to build. They may help signal, for example, how much time is left before an unsustainable policy mix must be changed. They may also provide a forum in which the financing needs of the country or government could be debated and assessed and, say, an upcoming bulge in principal payments could be reprofiled or bridging finance arranged. In other words, there seems to be value in creating the means by which a government and its private creditors could have the kinds of conversations that representatives of an enterprise might have with their bankers.

After a sovereign default happens and a concerted debt-restructuring mechanism is brought into play, it is equally important that it contain or facilitate an open channel of communication through which creditors can express their views to the government on its policies and hear back from the government what its policy priorities and constraints are and why. Indeed, it seems best to create that channel well before the crisis — while still under normal circumstances — and have it already operating so as to build confidence between the private creditor community and the government. Certainly, it would be an important asset to have when a debt-restructuring process becomes necessary.

There is already a long-established dialogue of the debtor government and the official international community, undertaken through regular IMF policy surveillance and through negotiations that governments undertake when they seek Fund-supported adjustment programmes. Although surveillance reports and Letters of Intent for adjustment programmes are increasingly available to the public, giving creditors a perspective on policy choices made, it is not the same as the give and take in a conversation. Having a channel for such dialogue of the government with its private creditor community would give effect to the internationally desired

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[12] See IMF, "Investor relations programmes: Report of the Capital Markets Consultative Group (CMCG) Working Group on Creditor-Debtor Relations," 15 June 2001.

[13] That is, "sell-side" firms use the information to help market the debtor's bonds, and investment analysts use it to develop their "buy" and "sell" recommendations to clients; whether or not they also engage in "insider trading" is another matter. Except for directly lending commercial banks, the "buy side" is often less directly informed.

"constructive engagement of the private sector by the official sector" and serve as a concrete part of the process for "private-sector involvement" in crisis prevention and crisis resolution.[14]

The Monterrey Consensus, adopted by the Heads of State and Government and other senior officials at the International Conference on Financing for Development in March 2002, highlighted such "consultation mechanisms" and encouraged "public/private initiatives that enhance the ease of access, accuracy, timeliness and coverage of information on countries and financial markets, which strengthen capacities for risk assessment".[15] One concrete proposal in this regard, presented at the International Business Forum of the Monterrey Conference, was to create an independent Global Clearinghouse of multi-sourced information on developing countries and relevant industries with an investor-friendly "user interface", to which could be affiliated a series of Internet-based government-investor communication networks to link together creditors in different parts of the world with various government officials in specific debtor countries on an ongoing basis.[16]

One can argue from the discussion in the previous section that creditors holding claims on a bankrupt government have a stake in the prompt economic recovery of the country. They should be advocates for early, effective and growth-oriented adjustment. They are not, however, "stakeholders" in the popular sense of warranting even an indirect role or responsibility in determining the policies followed by the government. The voices of those stakeholders in policy formation, especially domestic civil society, the press and different branches of government, are essential for national ownership of adjustment programmes. None the less, creditors should have a "voice" in the policy dialogue, one that will help retain creditor confidence in the government, perhaps facilitate informal processes for temporarily easing debt-servicing obligations without default, and perhaps even help broadly structure a debt reduction agreement before default becomes necessary, leapfrogging some of the steps in standard debt-restructuring negotiations. It might also help rebuild confidence after it is lost through default, an essential step in the eventual return of the debtor to normal external borrowing relationships.

A "stay" during crises so creditors behave collectively

The problem with the preceding conclusion is that private creditors to a bankrupt entity,

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[14] The terms in quotation marks were prominent in the 24 September 2000 communiqué of the International Monetary and Financial Committee at the Prague Annual Meetings of IMF and the World Bank, endorsing a framework for private sector involvement in crisis prevention and management (see *IMF Survey*, 9 October 2000, pp. 314-317).

[15] United Nations, *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (A/CONF.198/11), Chapter I, Resolution 1, Annex, paras. 24 and 25.

[16] A prototype of the Global Clearinghouse is currently being developed for Ghana and Mauritius as pilot cases, with the support of Norway and the Ford Foundation, and potential government-investor networks are being designed for these countries and Mexico (for access to the working model, contact Samuels_Barbara@bah.com). For background, see Barbara Samuels, II, "Strengthening information and analysis in the global financial system: a concrete set of proposals," United Nations Department of Economic and Social Affairs, Discussion Paper No. 23 (June 2002).

governmental or private, typically do not see themselves as having any stake in that entity. Rather, each individual creditor tries to recover as much of its loans to the entity and as fast as possible, assuming that each other creditor is thinking the same way. In reality, the average creditor will recover more of its loans by working together with other creditors, although the fleet-footed individual who is willing to risk expensive legal costs can come out better (or worse) than the average. Bankruptcy court, such as processes under chapters 11 and 9 of the United States Code, are precisely aimed at forcing the creditors together for "collective action" by limiting their ability to act individually. A major instrument for this is the "stay on litigation" against the bankrupt firm (chapter 11) or municipality (chapter 9) while it is under the court's protection. On this analogy, a stay on litigation has been proposed as a tool to promote collective action in the case of sovereign bankruptcies.[17]

In the development of the framework for orderly workouts from debt crises, IMF has developed guidelines under which it accepts that sometimes a government needs to suspend its debt servicing to private creditors. IMF would signal its acquiescence in such situations by continuing to make its own loan disbursements to the government after the government had suspended foreign private debt servicing. This is called "lending into arrears."[18] However, "lending into arrears" does not protect the debtor government from the courts of the creditors.

One may ask, as this gap in legal protection of the sovereign has existed for over 50 years of IMF existence, why was it never filled? The answer seems to be that until recently creditors rarely sued defaulting sovereigns. For countries whose creditors have been primarily official institutions, except for financing of trade, a formal stay is unnecessary, as short-term trade credits are largely self-financing and long-term ones are often insured by official export credit agencies that cover the losses of the private lenders in the event of default. Neither the official export-credit agencies that end up holding the insured claims, nor other official creditors will attempt to force immediate payment by the sovereign in crisis through the courts.

In addition, after the 1970s private lending boom crashed in the 1980s, creditors also did not as a rule attempt to immediately collect on their defaulted loans through the courts and thus there was no pressure for a formal international stay arrangement. The defaulted private lenders had been primarily banks (indeed, most of the bond issues outstanding continued to be serviced even when countries defaulted on their bank loans), and banks were not under pressure to immediately resolve the situation. For one thing, banks do not have to immediately take an accounting reserve against bad debt or write down the value of the loans carried on their books, as they do not publish balance sheets daily. For another, many of the foreign bank creditors had business interests in the defaulting country (e.g., retail, investment or private banking businesses) and thus had reasons not to antagonize local government officials with legal action. For a third thing, "sharing" clauses in multi-bank syndicated loans, the most common instrument for large loans, required that if a bank was successful in its suit it had to share the proceeds with

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[17] For terminological clarity, a "stay" is here quite different from a "standstill" on debt servicing. A stay temporarily prevents creditors from having a court enforce a contractual obligation. A standstill is the actual suspension of debt-servicing payments (partial or full), which may be protected by a stay on creditor litigation.
[18] For additional details on the current policy, see "IMF Board discusses the good-faith criterion under the Fund policy of lending into arrears to private creditors," IMF Public Information Note 02/107 (24 September 2002).

the other lending banks. In other words, banks holding defaulted external debt enjoyed the time and incentives to try to resolve the debt crisis through privately organized collective action. They did not need to bring to bear any formal bankruptcy mechanism.

Moreover, organizing themselves into Advisory Committees and London Clubs to address defaulted government debt was made easier by the relative concentration of the international banking industry, and because the bulk of the lending was in the form of syndicated loans, as noted above (sometimes, a few lead managers would represent 500 or more banks in a single syndicate).

The difference today, as many authors point out, is that a large percentage of the private financing of emerging economies is in the form of securities, especially bonds. Bond financing is more volatile than bank lending, as the number of lenders (i.e., bondholders) is usually far larger and bonds are more easily traded. Also, mechanisms for organizing bondholders are far less developed than for banks. Individual bondholders might thus feel less confident that their interests would be protected than a small bank whose syndicate was participating in a London Club restructuring negotiation.[19] Individual bondholders might thus look more quickly at trying to protect their interests through the courts than bank managements.

In contrast to bank loans, bonds have to be "marked to market" every day. This means that the owners of the securities have to immediately reflect the weakness of defaulted debt in their portfolio of securities. Moreover, most securities investors in emerging markets have little ongoing business interest in the country, which makes more credible the threat that some number of them would seek individual redress in the courts of the country where the securities were issued, or a small group might file a class-action suit, as has happened in Argentina.[20] It is not obvious that a court would give satisfaction to such creditors, but several ongoing court proceedings in various jurisdictions might well complicate negotiations on behalf of all bondholders to arrive at an agreed restructuring with the debtor. A legal "stay" means not having to deal with this complication.

At the same time, the stay should be temporary when it is invoked. While the threat of the stay encourages creditors to take a collective approach to resolving the debt crisis, a long stay would give the debtor the opportunity to delay negotiations. One approach might thus be to empower the debtor government to declare an initial stay, valid say for only 60 days (perhaps subject to IMF Executive Board endorsement after enactment), after which it would expire. In that period, the creditors would need to form themselves into creditor committees and should begin negotiations with the debtor. The creditors represented by the committees should be empowered to extend the stay as needed, say in 60-day intervals. This would give the creditors represented by the committees collectively the power to prevent defections, which it would be in

[19] Even so, the secondary market in bank debt that arose in the 1980s was available as a way for banks that did not want to wait out the negotiations to sell their participation in a syndicated loan, albeit at a substantial discount from face value. In addition, strategic investing banks and banks that had mainly sought a financial opportunity in lending to the sovereign followed different debt recovery strategies, which led to the introduction of various "exit" offers to the latter creditors in successive restructuring rounds, while the longer-term players stayed in the pool.
[20] See Deepak Gopinath, "The debt-crisis crisis," *Institutional Investor*, August 2002, pp. 36-40.

their interest to do as long as the negotiations and the economic adjustment programme were judged to be making adequate progress. However, there might be an upper limit to the number of extensions, as there is also a need to create strong incentives to bring the full negotiation to a close.[21]

Organizations representing private creditors have opposed including the stay in any new sovereign debt restructuring mechanism. They believe it unacceptably compromises "creditor rights".[22] Indeed, its purpose is precisely to restrict individual creditor actions in order to increase the recovery by an entire class of creditors. Another reason for opposition to a stay is a fear that before default, the government might more readily threaten suspension of debt servicing, or actually default when it was not yet inescapable, understanding the stay would protect it.

In sum, although there is a point to the case against a stay, there is also much to argue for having it. Perhaps given the creditor concerns, a more refined legal instrument that does not broadly challenge creditors' rights to go to court could substitute for a stay, but it should have an equivalent effect to a stay in preventing creditor litigation during the debt negotiations.[23] What is essential is that individual creditors not be able to disrupt or delay the resolution of the sovereign's debt crisis. What is most desirable is if all creditors see that their individual interest is best served through their collective interaction with the indebted sovereign.

Ground rules for organizing a sovereign's debt renegotiation

The general strategy in complex debt-restructuring cases has been for the debtor government to negotiate with separate and self-organized classes of creditors, such as commercial banks, bondholders (if at all), domestic creditors (if required), the Paris Club, and so on, usually in a context given by an IMF-supported macroeconomic adjustment programme. Although IMF approval of the adjustment programme usually comes before the debt negotiations are completed (and is a precondition for the Paris Club to act), the IMF programme is itself a

[21] Legal experts in bankruptcy observe that an initial, debtor-initiated 60-day stay might not be needed, as it would be difficult for a creditor to mount an effective legal case, obtain a favourable judgement in a relevant court and identify appropriate assets of the defaulting government to try to attach in that time period. Nevertheless, the first stay would have symbolic power, marking the start of the process and the subsequent creditor-endorsed stays would signal that the cooperating creditors were working effectively to arrive at a solution to which they would seek to bind all creditors.

[22] It seems curious and worth explaining why an abridgement of creditor rights in domestic bankruptcy proceedings is acceptable and the comparable abridgement in the case of a sovereign is not.

[23] The IMF Staff, concerned about the possibility that overly broad powers could be conferred by a general stay, have proposed that the SDRM employ a more limited "hotchpot rule", which in essence subtracts from a successfully litigating creditor's share of a final group settlement whatever was won through its litigation, neutralizing its gain. The Staff coupled this proposal with a possible supplement, which would enjoin enforcement of individual creditor court actions that would otherwise undermine the collective restructuring agreement (see IMF, "The design of the Sovereign Debt Restructuring Mechanism — further considerations" (EBS/02/201), 27 November 2002, paras. 124-141).

compromise between proposed adjustment policies, the financial resources required to support their implementation, and the amount of funds and debt relief judged likely to be supplied by official and private sources.

The aim is a coherent and adequate package of policy measures, financing and debt relief that brings the country to a sustainable situation at the end point of the adjustment process. The adjustment path should be "growth oriented" and contribute to the struggle to eradicate poverty. Design of the package thus entails a judgement over what a sustainable overall level of debt would be for the country and how quickly the country might move to the sustainable situation. It depends on the outlook for the international and domestic economy, the amount of new financing that official or private inflows might provide (e.g., through foreign direct investment), the socially and politically tolerable rate of structural adjustment, and the need to maintain basic social services, indeed, in many cases to increase spending on them.

There is no magic formula that yields the "correct" package of actions, and experience over the past quarter century suggests that often several economically and socially costly attempts have been needed, sometimes stretched out over many years, before sufficient steps are taken to enable a country to "graduate" from debt-crisis status, if then.[24] Indeed, there is good reason to seek an improved way to arrive at the warranted package of actions, one that also shortens the time needed for the country to renegotiate its debt burden.

The major proposals that have circulated in recent years for improved mechanisms for arriving at the debt restructuring part of the package have taken different approaches. The least ambitious proposal, to insert or strengthen "collective action clauses" (CACs) in sovereign bond contracts, seems the least likely to make a difference. The clauses would address how to mobilize the holders of any specific bond issue and bind-in its potentially recalcitrant members, principally by specifying the precise majority required to change the financial terms of a bond.[25] They would also commit the issuing government to appropriate standards of behaviour in its relations with bondholders.

One may raise, however, a question about the CACs proposal. Although the international community has endorsed CACs in one form or another since 1996 and although no international action is required for bond buyers or market professionals to demand them and for sovereign issuers to introduce them, why has their use not increased?[26] The "revealed preference" of the buyers and issuers in the international bond market suggests there may be concerns that CACs would not actually strengthen creditor interests in a default situation compared to current standard bond contracts. It might even be that advocates of CACs in the business community,

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[24] This is illustrated by the sequence of negotiations and policy initiatives needed to address the 1980s debt crises, and the even longer span of time and greater number of policy iterations to resolve the still ongoing crises of the heavily-indebted poor countries.

[25] In addition, a "sharing clause", if it became standard in bond contracts, as in syndicated bank loan agreements, as noted above, could make a formal stay on litigation unnecessary. Presumably, suppliers with defaulted claims on a government could still seek to litigate, but this did not seem to be a major problem in the 1980s and it would presumably not be one today either.

[26] The question is well posed in William Bratton and Mitu Gulati, "Perfect market puzzles: five observations from the world of sovereign debt" *Economic and Political Weekly* (Mumbai), 6 July 2002, pp. 2702-2704.

which opposed them until recently, now see them mainly as a weapon with which to defeat the stronger SDRM proposal.

Meanwhile, bond-issuing emerging economy governments fear that adopting CACs in their bond documents would send a signal to international investors that default was more likely, raising risk judgements and thus interest rates. The logic is not clear, as few insurance companies believe that purchasers of dual airbags for automobiles intend to smash their cars into trees or other cars. But the concern is about market psychology and not logic. Emerging market issuers will surely have no problem inserting CACs into their bond contracts once they become the global standard and threaten no signalling effect.

One important shortcoming — and frequently made criticism — is that CACs beg the question of how to organize the multiple classes of creditors of a single country for negotiations with the debtor, let alone how to bring together into a single class just the holders of bonds issued in different currencies and under the laws of different financial markets. Proponents of CACs have recently responded to this criticism by advocating the convoking of "an informal, country-specific advisory group comprised of leading market participants from a broad spectrum of financial institutions," which would enter into discussions with the authorities in a country in difficulty and if "broad debt restructuring" were required the advisory group could "give way to constructive dialogue between the debtor country and a broad spectrum of creditors reflected in a creditor group."[27] Such an informal advisory group could emerge smoothly from the "continuous conversation" mechanism discussed above, although one might wonder about how representative its members might be in the actual negotiations if they were self-appointed, as seems indicated.

The Sovereign Debt Restructuring Mechanism (SDRM) proposed by IMF would also encourage formation of such an advisory/negotiating creditor group in complex cases, but would put it on a sounder footing. Under the SDRM, all creditors that would participate in the restructuring of the sovereign's debt would be formed into separate classes. A new international legal mechanism, the Sovereign Debt Dispute Resolution Forum (SDDRF), would oversee the formation of the classes, validate the claims of individual creditors, and resolve disputes on the allocation of individual creditors to the classes. It would also oversee creditor voting within each class, as on such matters as who should represent them in their negotiations. The chosen class negotiators would be charged with developing with the sovereign a precise restructuring proposal for their class. In addition, a steering committee of the various classes of creditors might be formed to coordinate their various negotiations and check on the coherence of the overall financial package that emerges. The sovereign would then formally propose the component draft agreements to each class, which would formally vote on them, all of this, again, overseen by the SDDRF. The overall debt agreement would be considered adopted when approved by 75 per cent of the outstanding principal of registered claims in each class.[28]

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[27] See "Sovereign debt restructuring," discussion draft of a joint statement by Emerging Markets Creditors Association, EMTA, Institute of International Finance, International Primary Market Association, International Securities Market Association, Securities Industry Association and The Bond Market Association, 6 December 2002, p. 8 [available at www.emta.org].
[28] See IMF, op. cit., especially paras. 157-168 and 183-208.

While this seems to be a powerful overall approach, it has a number of shortcomings, which, if addressed, would significantly strengthen it. For example, as currently proposed, an important group of creditors for many developing countries would not be included, namely the official bilateral creditors. The Fund Staff instead envisaged a parallel process of negotiations in the Paris Club, apparently following its existing practices and precedents.[29] One reason for keeping the Paris Club separate is that the results of its negotiations would be hard to reconcile with those of the SDRM. Above all, unlike private creditors, the Paris Club has been very reluctant to grant "stock of debt" reductions, except for the poorest countries. Rather, it reschedules debt servicing obligations in arrears and falling due during limited future periods. In addition, each Paris Club arrangement is only an informal "Agreed Minute", which then has to be negotiated into individual debt-relief agreements with the authorities of each Club member. The indebted country thus has to undertake repeated sets of Paris Club negotiations over time. Moreover, the debtor is expected to seek comparable treatment from its other bilateral official creditors that are not Club members, which are often other developing countries. This is a high-cost mechanism, especially for the debtor, and would not allow for closure on the question of whether the country will have eliminated its debt overhang when it completes its SDRM arrangement.

In fact, the Paris Club could make new rules so that its agreements were more like those arrived at under an SDRM mechanism. It seems that once such a mechanism is created, however, the Paris Club will have outlived its usefulness. The Paris Club treats mainly two types of official loans: export credits and direct loans by its member governments, including official development assistance (ODA). Each type could be treated as a separate creditor class within the SDRM process. While ODA loans involve a policy matter that might warrant special guidelines or a special class within the SDRM, the other loans are essentially commercial activities of States, mainly promoting the exports of their countries through advantaged terms of export financing, typically for large-scale purchases such as airplanes, nuclear power stations and capital equipment. As essentially commercial activities, even though of governments, they should be treated like other commercial credits. That is, the export credit agencies (both Paris Club members and non-members) could be grouped together under the SDRM as a mandatory separate class. Not only would this facilitate more efficiently arriving at an appropriate overall package for the debtor, it would bind in non-Paris Club members and reduce the expenses of the export credit agencies themselves in negotiating each Paris Club bilateral round. Instead, they would settle their claims on the debtor in one relatively quick negotiation, which, by the structure of the process, would take account of the inter-creditor equity issues among bilateral agencies that underlay the formation of the Paris Club in the first place.

It should also be possible for the steering committee to raise questions about the overall adequacy of the country's proposed adjustment programme and its financing envelope.[30] The steering committee could conceivably even reach the conclusion that the overall financial and policy package would not lead the country to a sustainable debt situation, in which case their

[29] Ibid., paras. 74-82.
[30] As was the practice under the Bank Advisory Committees in the 1980s, the steering committee would probably set up its own technical economic subcommittee to advise it.

post-agreement credits would be of uncertain value. The committee might thus urge the debtor government to reopen its discussions with IMF.

As the overall package would have usually been supported and endorsed by IMF, it may be seen that the closeness of IMF to the SDRM might be a problem. What happens if the creditors conclude that sustainability requires relief from servicing debt owed to the multilateral financial institutions? Those institutions could reject this argument, but it should be addressed on its merits. It is not clear, however, where that debate would take place. It does not appear that such concerns could be addressed to the SDDRF. Perhaps the only avenue open to the creditors would be to reject the debt restructuring package reached under the SDRM by voting it down, which is not an attractive option.

This is, naturally, a highly sensitive issue and one that the IMF Staff have been concerned about, in particular as IMF is itself a major creditor of countries expected to use the SDRM. It should not, however, be out of the question that debt owed to multilateral institutions would in certain extreme cases have to be relieved in one way or another. This is one lesson of the international process for addressing the difficulties of the heavily indebted poor countries. As that situation highlights, it may be a highly unusual set of circumstances that creates a situation requiring relief of multilateral debt servicing, but such circumstances do occur.

At this point, one may ask the more general question, how would one know that the overall package, of which the debt-relief agreement is a part, would be adequate or appropriate? It would have resulted from a complex negotiation and reflect the relative bargaining strengths and strategies of the negotiators. Indeed, a group of civil society organizations has argued that an SDRM-type of process would not produce an adequate outcome and instead have proposed a different approach, called an International Fair and Transparent Arbitration Process (FTAP). It would replace the negotiations between debtor and creditors with an arbitration process.[31] In that model, a panel of five arbitrators, chosen in a particular way that aims to ensure their independence and balance, would hear testimony of all relevant stakeholders in the sovereign's debt crisis, including representatives of the poor, and then determine a fair solution. The argument here is that instead of negotiations among unequally backed parties, arbitrators (assisted by internationally supplied staff) would reach a better solution.

Usually, when arbitral proceedings are used to settle financial disputes, provision for them is made in the original contract or in the governing law or administrative regulations. Operating at the international level, the FTAP would have to be created by treaty, as it would apply in principle across the board to all financial obligations of the sovereign, regardless of the terms of individual loan agreements. Creditors who worry about the abridgement of their rights during a temporary stay of litigation under an SDRM would presumably have apoplexy over this proposal. What it serves to do, however, is focus on the matter of the adequacy of the overall agreement in terms of its economic and social implications, and this is an essential point. Also,

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[31] For a detailed presentation, see Thomas Fritz and Philipp Hersel, *Fair and Transparent Arbitration Processes: A New Road to Resolve Debt Crises*, A Discussion Paper, Berlin and Aachen, August 2002 [see www.blue21.de or www.misereor.de]. See also Jubilee Research (New Economics Foundation), Jubilee South and other organizations (important initial and continuing work on the idea has been done by Kunibert Raffer at the University of Vienna).

by recommending use of an arbitral panel, the FTAP proposal suggests that there is value in bringing to bear the viewpoints of reputable individuals who are outside the process of the direct negotiations.

This points to another possible amendment of the SDRM proposal. Instead of FTAP arbitrators, mediators might serve as external advisors to the SDRM process. Mediation works when all sides to a dispute believe that the mediator's suggestions are competent, unbiased and aimed at an effective solution. The mediator's main function is not to get a "better deal" for one party or another to a dispute, but to facilitate reaching an effective settlement. Mediators can save all disputants time and resources (a major attraction to employing mediation), as they develop a sense of how far the different negotiators would be willing to go on the various aspects of the contest, and thus where the true middle ground might lie. Not being participants in the negotiations themselves, they can more easily see and assess the overall adequacy of the evolving package, or at least respond to concerns about adequacy raised by one group of actors or another.

At the United Nations, where mediation plays a large role in attempts to resolve political disputes, the Secretary-General has suggested considering it as part of a mechanism for addressing debt crises. Following extensive discussions with IMF, the World Bank and other partners, he reported at the end of 2000 to the Preparatory Committee for the International Conference on Financing for Development that

> "Policy makers need to retain enough flexibility to respond to individual situations; this calls for an appropriate balance between the elements of judgement and clear rules… This could be achieved by adding to the menu available to debtor countries 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 or other creditors. The use of such a mechanism, which could be invoked under specified conditions by a country already cooperating with IMF and other international financial institutions, would bring together committees representing bank creditors, bondholders, the Paris Club and other bilateral official creditors, as appropriate, plus the debtor Government. For instance, an independent mediator, assisted by IMF and other experts, could be charged to facilitate arriving at an agreed financial package. The aim would be to ensure fairness, reduce financial uncertainties quickly and lower the cost to creditors as well as to the debtor of arriving at a final debt restructuring agreement… **To complement other initiatives under way, the potential value of a mediation-type mechanism deserves particular consideration…**"[bold in original].[32]

Mediation would be available as a service that participants in the negotiations to

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[32] United Nations, "Report of the Secretary-General to the Preparatory Committee for the High-level Intergovernmental International Event on Financing for Development" (document A/AC.257/12), 18 December 2000, para. 125.

restructure a sovereign's debt might (or might not) draw upon to advance more expeditiously to a comprehensive and effective solution. In fact, no formal bankruptcy regime is needed for negotiators to avail themselves of mediation if they jointly so decide and they can identify a mutually acceptable mediator.

Finally, it should be observed that the advocates of FTAP are absolutely right about the need to be concerned about poverty and development in debt-crisis countries. Debt itself is obviously a politically sensitive point that poverty-eradication advocates can focus attention on, as most people will identify more readily with a debtor than a creditor. However, debt is only one potential pressure point and not central to the continuation of poverty in every country. Advocates indeed understand this and the need to also put pressure on other aspects of government policy and international cooperation.

The nations of the world committed themselves in the Millennium Declaration to achieving a set of social and economic goals and the international institutions are committed to realizing those goals.[33] The agreed international follow up on implementation includes in-country reviews, as well as global monitoring. When it is seen that any country is not on track to achieve the goals, it behoves policy analysts in the country and in the international community to explore why. If the reason is even partly attributable to a debt crisis, that concern should inform the process for restructuring the country's debt situation.[34]

International legal and oversight issues

IMF has presented the SDRM as a "statutory" approach to sovereign debt restructuring, meaning that it would become part of international law and have a number of mandatory features. Central among them are the processes described above for reaching the debt restructuring agreement once the debtor government invokes the SDRM, as well as the decisions of the SDDRF. Wary of the radical change that would be embodied in a strong, new, international process that oversaw sovereign bankruptcies, IMF proposed strict limits on the juridical powers of the SDDRF, while also trying to assure its independence. Another legal issue is how the SDRM as a whole would be made into an international agreement having the force of law. IMF proposed that SDRM be adopted as an amendment to the Fund's Articles of Agreement, a treaty to which all Fund member countries are bound. Each of these issues remains highly controversial at this time.

As the current debate over the SDRM is quite heated, it is important to realize that even if there were a strong international consensus on the SDRM, it would take at least two to three

[33] Adopted at the Millennium Summit, New York, 8 September 2000 (see United Nations, General Assembly resolution 55/2).
[34] This suggestion speaks to a guideline in the Monterrey Consensus, namely that "Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress toward the achievement of the development goals in the Millennium Declaration" (United Nations, *Report of the International Conference…*, para. 49).

years to bring it into legal force. First, a formal draft amendment would have to be proposed by the Fund's Executive Board and approved by the Board of Governors, in both cases by a majority of votes cast. That could happen over a period of months, but it would then have to be "accepted" by three fifths of the membership accounting for 85 per cent of the total voting power. Before ratifying the amendment, each country would have to "take all necessary steps required under its own domestic law to enable it to accept [the] new treaty obligations," which in some countries would require explicitly re-legislating a number of domestic laws.[35] In light of the degree of controversy surrounding the SDRM at this time, including evident opposition expressed by a group of countries in Latin America and the Caribbean,[36] the last step would take considerably longer than only a few years.

One advantage claimed for adopting the SDRM through an amendment to the IMF Articles is that it does not require the endorsement of all countries to which it would apply. Once the required number of countries accepts the amendment, it is binding on all members. Given the distribution of voting power in IMF, a large number of developing countries could oppose the draft amendment and it could still be adopted. That might improve the chances of adoption, but such an approach would violate all sense of the international pledge as in the Monterrey Consensus to increase the "effective participation" of developing countries and countries with economies in transition in the important international efforts underway to reform the international financial architecture.[37] In other words, proponents of the SDRM should be satisfied with nothing less than full consensus on the SDRM at each stage of the approval process. In this regard, the standard for adoption of the SDRM should not be such that it could be adopted over the objections of a significant number of developing countries.

Negotiators of a self-standing treaty would, in contrast, be free to set whatever criteria they deemed appropriate for the treaty to come into force. There would be an additional advantage to adopting the SDRM through a free-standing treaty, namely, it would allow more flexibility in how the legal instrument itself were designed. For example, one concern of the Fund and of critics of the SDRM is that, as a major creditor, IMF would not be a neutral party in the negotiations that the debtor country enters with its other creditors. The Fund does not participate directly in those negotiations, but, as noted above, it is central to the development of the country's adjustment programme and how it is financed with new funds and debt relief. It thus sets the parameters for the debt negotiations. This potential conflict of interest has not been directly addressed in the design of the SDRM, except in so far as it pertains to creating a space between IMF and the SDDRF. The Fund has thus proposed a complicated mechanism by which experts drawn from relevant international professional organizations and other sources would advise the Managing Director of IMF on prospective candidates for a "selection panel" that would in turn recommend names to him for selection as candidates for the pool of SDDRF

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[35] IMF, op. cit., para. 282.

[36] See Statement of Mr. Pedro Malan on behalf of the Constituency comprising Brazil, Colombia, Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, and Trinidad and Tobago, International Monetary and Financial Committee, International Monetary Fund, Washington, D.C., 28 September 2002, paras. 21-27.

[37] United Nations, *Report of the International Conference…*, op. cit., para. 53.

judges. The Managing Director would thus form his list and submit it for approval or rejection as a whole by the IMF Board of Governors.[38]

One might ask why does the IMF need to be involved in the selection of the SDDRF judges at all? The answer is because the SDRM would be created by an amendment of the IMF Articles. That is, it is not feasible for IMF to engage or commit another international institution or body through an article of its own constitutional agreement. Were the SDRM to be adopted by a stand-alone treaty, this problem would not arise and the process for selection of the SDDRF judges could be designed in a more straightforward way. They could be chosen by other credible, international processes, utilizing say the United Nations or a separate governance body established under a freestanding SDRM treaty. Indeed, there is nothing in the operation of the SDRM negotiations themselves that need directly involve IMF, especially if an independent mediator could respond to concerns expressed by one side or another about the overall package. Except in the very rare cases when its own loans had to be restructured, IMF could stay fully at arm's length from an SDRM mechanism created under a stand-alone treaty.[39]

While establishing the SDRM through such a treaty could address the criticism of the direct involvement of IMF in the process, a treaty would still be subject to the cry that a statutory approach is not warranted for sovereign debt restructuring and would take too long to bring into force. The main suggested alternative, as noted in the discussion of CACs above, is the contractual one. That is, instead of a new international agreement that would supersede the terms of loan contracts, advocates of the contractual approach argue for changing the terms of the contracts themselves. Thus, instead of government negotiators and legislatures determining what the debt-restructuring process would be, lawyers for the creditors and the debtor would do so, guided by model clauses such as are currently being developed by private creditor associations and that could be endorsed by an intergovernmental body. However, it seems that, barring a wholesale swap of outstanding debt, quite a number of years would be required before the stock of sovereign bonds of any country would be converted to bonds with the new clauses. In short, the CACs approach, like the statutory one, would likely take considerable time to implement.

Moreover, as noted earlier, the contractual approach is a partial one, facilitating collective action by the investors in a particular bond issue or at most by all bondholders that would have otherwise fallen into the same class had there been an SDRM.[40] CAC advocates usually beg the question of enforcing collective action across lending instruments, other than to say that the debtor government should keep the bondholders or their representatives informed of proposed restructuring terms for other creditors (in the case of the SDRM, this would be assured by the steering committee).

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[38] IMF, op. cit., paras. 233-244.

[39] Were such a path taken, the treaty negotiators would do well to start from the detailed work on the SDRM by the IMF Legal Department, as cited herein.

[40] When the debtor defaults on an interest payment on a bond, there is first a grace period and then a per cent of the investors (as specified in the bond contract) may "accelerate" the bond, making it fully due and payable. Other bonds, payments on which fall due on other dates, may be brought into play by cross-default clauses, if not by actual default when payment is required. Restructuring all the accelerated bonds at the same time may then become the practical consequence of *pari passu* and other clauses in the bond contracts.

However, the Chairman of the Council of Economic Advisors of the President of the United States has taken a step further and recommended that comparable CACs be included in all private loan contracts (e.g., bonds, bank loans, trade credits).[41] Such clauses would also specify how to aggregate votes across the different creditor classes on a package of debt restructuring proposals covering each creditor class, paralleling the process specified in the SDRM proposal. In addition, acknowledging that an institution is needed to organize the negotiations and resolve disputes, he proposed that an independent forum take on the function of the SDDRF, with reference to that forum also included in each loan contract. That forum, unlike the SDDRF, would be established as a voluntary body, although how it would be formed was not explained.

In fact, Richard Gitlin, a prominent American attorney, had proposed creation of just such a forum at one of the "side events" at the Monterrey Conference on Financing for Development.[42] In his proposal, the Sovereign Debt Forum, which would be governed by a board drawn from private creditors, sovereign issuers and international organizations, would serve two functions. The first would be to enhance sovereign debt as an asset class through discussion among buy and sell-side practitioners in the bond market of the design of different lending instruments and their appropriate financial and legal terms, identifying and promoting best practices. The second would be to facilitate sovereign debt restructuring when needed. When approached by troubled debtors, the forum would help with early communication with creditors, assist in organizing the relevant parties and groups, make available facilitators or mediators from a standing panel, and provide informal adjudication processes as needed. It would also develop lessons for use in future debt restructurings based on the accumulation of experiences. Indeed, the forum could formulate principles for sovereign debt restructuring, or as other authors have described it, a code of conduct for crisis resolution. The proposal could be put into effect rather quickly on an ad hoc basis and, if backed by a significant part of the financial and official community, it could quickly gain the credibility to be useful in resolving a pending debt crisis.

Even if a voluntary mechanism such as the one above succeeds, it may still be useful to adopt a formal SDRM to serve as a backup with legal strength. As in the domestic context, the formal bankruptcy mechanism could prompt the relevant parties to come to mutual agreement "in the shadow" of the statutory mechanism. This does not necessarily mean, however, that the framework needs to be embodied in a treaty or amendment to the IMF Articles.

Professor Christoph Paulus, for one, has offered an additional approach. He emphasizes that the central issue in any bankruptcy is the collective action problem, or as he says, creating an "enforced community" of the creditors. He notes that national bankruptcy legislation establishes the process for creating that "community" for private entities or municipalities and that it binds in not only domestic creditors, but foreign ones as well, and also the domestic tax

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[41] R. Glenn Hubbard, "Enchancing sovereign debt restructuring," remarks at the Conference on the IMF's Sovereign Debt Proposal, American Enterprise Institute, Washington, D.C., 7 October 2002.

[42] Richard A. Gitlin, "A proposal: Sovereign Debt Forum," oral presentation at International Conference on Financing for Development Side Event "International insolvency framework: advantages for indebted Southern countries?" Co-organised by CIDSE/Caritas Internationalis, Church Development Service (EED) and UN Department of Economic and Social Affairs, Monterrey, Mexico, 19 March 2002.

authorities and even a foreign state, as when the bankrupt unit owes taxes abroad.[43] The power of a national legislature to thus bind in a foreign state in a domestic bankruptcy proceeding is generally accepted. Professor Paulus then posits taking one more step: he argues that the national legislature could also adopt a law specifying how the bankruptcy of the government itself should be handled. He admits that left to itself, the legislature would probably draft the law in a way that the creditors would find unfair. His answer is that a global institution, such as the United Nations, could adopt a model law on sovereign bankruptcy, based on a text drafted in a respected technical body such as the United Nations Commission on International Trade Law (UNCITRAL). The model law would have to embody procedures that were considered fair and effective by creditors, which means, to start, involving neutral third parties in overseeing the process of restructuring the sovereign's debt, much like the role the SDDRF would play. The pool of "third parties" would have to be maintained in a credible, independent forum, such as the International Court of Justice at The Hague and there should be a mechanism for review and revision of the model law based on lessons learned from experience. While the practicalities of this approach would need to be investigated, it underlines that new ideas on how to effectively restructure sovereign debt are not exhausted by the CACs and SDRM proposals.

Conclusion: more work is needed on debt restructuring

One might summarize the preceding discussion by saying that an international strategy for sovereign debt restructuring should have two goals: 1) to help a country that has fallen into a sovereign debt crisis to emerge from it expeditiously and with minimal social disruption, and 2) in so doing help to restore economic growth while preserving and strengthening the instrument of sovereign-risk lending as a fruitful source of private finance for development. The strategy as advocated here involves first fostering an ongoing relationship between a government and its private creditors that facilitates access to financing in normal times, smoothes the way to collaborative debt restructuring in a crisis, and helps speed the return to a normal relationship with foreign creditors afterwards. However, an institutional innovation also seems necessary for facilitating the debt renegotiations per se, when needed.

The SDRM as proposed by IMF is an important prospective innovation in this regard, although it is far from winning creditor or debtor endorsement in its current form. The SDRM nevertheless sketches out a superior method for addressing developing country debt crises than currently is available. This author, like others, would advocate changing certain features of the proposal in order to strengthen it, in particular regarding inclusion of bilateral official creditors in SDRM negotiations, making a mediation service available to negotiating countries, retaining an effective but temporary "stay" mechanism, and more completely separating the mechanism as a whole from IMF, as by seeking to enact it through a stand-alone treaty.

In any event, creating something like the SDRM is a long-term project, especially as

[43] Christoph G. Paulus, "A legal order for insolvencies of states," Humboldt University, Berlin, unpublished manuscript, 2002.

there is considerable opposition to the current proposal and there would probably be opposition also to the variations suggested here. Opposition could mean there is an unresolvable conflict of views and interests, or simply signal that the design of the SDRM still warrants improvement. The fact that bankruptcy regimes exist at the domestic level as standard features of the legal infrastructure suggests the latter to be the case. It is thus important to continue investigating how to improve the SDRM proposal, as well as consider non-treaty approaches to a more effective sovereign debt restructuring mechanism. A voluntary mechanism that could be set up by interested parties relatively quickly might help resolve individual debt crises and build confidence that a statutory approach is not needed, while an approach based on developing a model sovereign bankruptcy law can also be conceived as an avenue worth exploring.

In other words, considerable work remains to be done if a superior mechanism is to be established for restructuring the debt of sovereigns in economic crisis. Recognizing the broad imperatives involved, the signatories to the Monterrey Consensus issued the following challenge:

> "To promote fair burden-sharing and minimize moral hazard, we would welcome consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner…."[44]

Taking up this challenge is an urgent priority.

[44] United Nations, *Report of the International Conference…*, op. cit., para. 60.