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Sovereign Debt Restructuring: New Articles, New Contracts–or No Change?

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"The prospect of recurrent and uncontrolled financial crises is one of the gravest threats to an open and liberal international economic order... Recent events in Turkey and Argentina demonstrate that financial crises with potentially profound consequences for economic and political stability are not a thing of the past. They also demonstrate the continued urgency of finding practical and concrete means to handle the crises that do occur."

Arminio Fraga and Daniel Gleizer (2001)

Introduction and Overview

It was at the National Economists' Club in November 2001 that Anne Krueger, first deputy managing director of the International Monetary Fund, threw down the gauntlet. "There is," she said, "a gaping hole [in the international financial architecture]—we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors. It is high time this hole was filled."

Her own bold proposal—a Sovereign Debt Restructuring Mechanism (SDRM) involving a key role for the IMF—has had a catalytic effect on the debate. So too has the evolving situation in Argentina, as it headed inexorably toward drastic devaluation and dramatic default in what was called a "slow motion train crash." Why should a country whose net external indebtedness amounts to less than a quarter of its annual output be in such a mess?

A pessimist might claim it is "déjà vu all over again." An optimist could visualize things developing along the lines the US Treasury advocates. Despite the apparent dissonance, the approaches taken by the IMF and the US Treasury could be complementary rather than contradictory.

To address these challenges, the Institute for International Economics organized a conference in April 2002 involving policymakers, economists, and lawyers. In his opening survey of the field, Barry Eichengreen (2002) divided the contenders into three camps—those like Anne Krueger pushing for radical reform; those like himself advocating limited reform; and those who believe that markets are perfectly capable of resolving debt crises so no reform is necessary. True to form, Anne Krueger took the lead in advancing the case for institutional innovation and called for a change in the Articles of Agreement of the IMF. But the updated restructuring scheme she presented qualified the earlier version in reducing the planned role for the IMF and greatly increasing the part to be played by commercial creditors: for they, not the IMF, would decide whether or not a stay on payments would be extended. Where, in this spectrum of revolution, evolution, or stasis, would the United States take its stand? Given the blocking vote that the United States possesses on any changes of the Articles of Agreement of the IMF, this is a key issue. The answer was not long in coming, delivered the next day by John Taylor, an erstwhile colleague of Anne Krueger at Stanford, now speaking for the US Treasury.

The global economy now faces much the same problem as London bond markets did in the 19th century. The historical experience with corporate debt suggests two ways forward: the London-style solution of self-organizing creditors on the one hand, and the New York court-ordered approach on the other.

Addressing the serried ranks of assembled specialists—and the world's financial press—John Taylor began by agreeing that the option of doing nothing should be dismissed: reform of the process of sovereign debt restructuring in emerging markets is long overdue, he said. But then, in contrast to Anne Krueger, he advocated a decentralized, market-oriented approach in which sovereign debtors and their creditors put new clauses into their debt contracts to cover the contingency of debt restructuring. Effectively he professed his allegiance to the camp of limited reform. Since this approach, of inserting collective action clauses, had not been adopted in global financial markets despite earlier endorsement by the G-10 in the Rey Report of 1996, he also recommended that incentives be given in the form of sticks and carrots.

Where does this take things? A pessimist might claim it is "déjà vu all over again": nothing has really changed, and Anne Krueger's scheme was but interesting research—as John Taylor described it. An optimist could visualize things developing along the lines of the "workable, decentralized, market-oriented approach to reform" that the US Treasury advocates. A cynic might see the hand of Wall Street on the tiller.

This policy brief begins with an outline of the options on offer, principally the "statutory" approach of the IMF Sovereign Debt Restructuring Mechanism, and the "contracts" approach supported by the US Treasury. It includes a brief look at the history of corporate debt restructuring in the United Kingdom and the United States, to see what light this might shed on the current lively debate. There follows a strategic analysis of why reform is needed to limit the risk of investors' moral hazard in the international financial system and the value of "keeping your options open." After a brief discussion of next steps, we conclude that, despite the apparent dissonance, the approaches taken by the IMF and the US Treasury could be complementary rather than contradictory. The way forward is to proceed with contractual changes, while keeping the option of statutory intervention very much alive. The threat of statutory change would give lawyers the incentive they need to write ingenious contracts for creditor coordination!

Options on Offer

The problem to be faced, and the objectives of discussion, can be briefly stated as:

> "Far-reaching developments in capital markets over the last two or three decades have not been matched by the development of an orderly, predictable framework for creditor coordination, in which the roles of the debtor, the creditors and the international community are clearly spelt out. ... [This] imposes significant costs on all the parties involved....Our goal therefore should be the creation of better incentives to encourage the orderly and timely restructuring of unsustainable sovereign debts, while protecting asset values and creditors' rights."
>
> *Anne Krueger (2002, 7, 8)*

Historical Background

To manage the process of sovereign debt restructuring, the IMF has proposed legal procedures rather like those of Chapter 11 of the US Corporate Bankruptcy Code (Anne Krueger, 2001 and 2002). In seeking to improve on the work of the original architects at Bretton Woods, several others have pursued this analogy, as a recent paper by Rogoff and Zettelmeyer (2002) indicates. Further historical background was provided at the conference.

Buchheit and Gulati (2002) point out that for most of the 19th century, London bonds could not be restructured. But the problems this posed—forcing into liquidation many firms facing temporary liquidity problems—led to the insertion of the majority action clauses that now characterize London debt. (These clauses allowed a 75 percent majority in a meeting with a quorum to amend bonds in any respect.) In the United States, however, these flexible restructuring terms fell afoul of the statutory requirements for "negotiable instruments;" so they could not be listed. Collective action clauses were "the road not taken" and US markets operated with New York debt requiring unanimity for changing any of the payment terms. To cope with liquidity crises, procedures for court-ordered restructuring were developed instead, Chapter 11 being put in the statute book in the 1930s.

A key feature of the updated version of the sovereign debt restructuring mechanism is that the role and power of creditors are considerably enhanced. Besides approving the final restructuring agreement, it is they who would decide both the duration of the automatic stay and the granting of preferred creditor status to new private money provided after the stay.

As most emerging-market debt is denominated in dollars, it is hardly surprising that New York terms have become widespread for sovereign debtors. This makes sovereign debt extremely difficult to restructure. As Lee Buchheit suggested (drawing from Buchheit and Gulati 2002), the global economy now faces much the same problem as London bond markets did in the 19th century. The historical experience with corporate debt suggests two ways forward: the London-style solution of self-organizing creditors on the one hand, and the New York court-ordered approach on the other.

In supporting the widespread adoption of collective action clauses, Eichengreen and Portes (1995), the Rey Report (1996), and now John Taylor (2002) are taking the former route. But by advocating an international bankruptcy court and/or workout procedures loosely modelled on Chapter 11 of the US Bankruptcy Code, Jeffrey Sachs (1995), Steven Schwarcz (2000), and now Anne Krueger (2001 and 2002) are effectively taking the other route.

Statutory Proposals

After this backward glance at history, it is time to turn to the learned language of law. As a guide to what follows, we begin with the main elements of Chapter 11 bankruptcy, and then indicate the market failures these are designed to address.

- The first priority under bankruptcy law is to stop a creditor grab race for the debtor's assets—this can only be done by an *automatic legal stay* on the enforcement of all lawsuits and claims against the debtor when the latter "files for protection."
- To keep the business as a going concern—and to finance its reorganization—preferred creditor status is given for those providing new money—so-called *debtor-in-possession (DIP) financing.*
- To solve the collective action problems that occur during negotiations—the problem of "holdouts"—the basic mechanism is to override the contractual provisions of existing bond covenants (which may call for unanimity) by *supermajority voting.* The voting rules for each and every class of debt require a majority of at least two-thirds in the amount of outstanding claims and one half of the holders of debt to enforce the restructuring agreement.
- Since supermajority voting provisions require all classes of creditors to agree, *cramdown* provisions (which allow confirmation of a plan even if not all classes vote in favor[1]) are also needed.

Experience of corporate reorganization has demonstrated that all four elements are needed to give both the opportunity and the incentives to achieve efficient restructuring of outstanding debt obligations. These elements are summarized in the top row of table 1.

The market failures giving rise to these legal provisions were unforgettably portrayed by Nouriel Roubini[2] whose caricatures are surely worthy of graphic illustration, perhaps in the style of James Gillray, the famous 19th century illustrator. First there is the *rush for the exit*, by those who cease rolling over debt and accelerate payments wherever pos-

1. It is essentially a means of enforcing a plan even when junior creditors hold out (i.e. fail to provide a supermajority vote).
2. Who is, in fact, sceptical of the extent to which these market failures may justify a statutory approach to sovereign debt restructuring. See Roubini (2002).

Table 1 Key features of debt workouts

Scheme/ Features	Stopping a grab race	Financing reorganization	Restructuring debt	Restraining holdouts
Chapter 11 bankruptcy	Payments standstill *plus* automatic legal stay	Preferred status for new money (DIP finance)	Negotiations under court supervision	Supermajority voting plus cramdown
Krueger (2001) SDRM-1	Capital controls plus automatic stay	Preferred creditors plus limited IMF lending	Negotiations supervised by IMF plus IMF program	Supermajority voting *plus* arbitration?
Krueger (2002) SDRM-2	Payments standstill *plus* short stay, which may be renewed*	Preferred creditor status for new money*	Negotiations supervised by neutral agency *plus* IMF program	Supermajority voting* *across* all classes
Taylor (2002) collective action clauses	Initiation clause to allow for payments to be suspended		Rules for meeting governed by a representation clause	Supermajority voting clauses *plus* arbitration
Status quo	Unilateral standstills	IMF "lending into arrears"	Bond swaps *plus* Paris Club for bilateral debt	Exit consent

* to be decided by a supermajority vote of creditors.

sible—this calls for a payments standstill. The need for an "automatic stay" is to check the *rush to the courthouse* by creditors trying to be first to establish their legal claims. Then, in the courtroom itself, there is the problem of *freeriding* by "rogue creditors" who lie low as write-downs are negotiated, only to reappear later in the proceedings with threats to block the restructuring unless they are offered much better terms themselves.[3] Supermajority voting is designed to bind these "holdouts" to accept the agreed settlement. In addition, if bankruptcy provisions are too lenient, there is the *rush to default* by debtors who may have the capacity but lack the incentives to abide by the terms of their debt contracts.[4]

Armed with these legal definitions and images, we come to the IMF's proposal for global financial reform. The new *Sovereign Debt Restructuring Mechanism* outlined by Anne Krueger in November 2001 (SDRM-1 in table 1) was clearly inspired by the analogy of Chapter 11 and provided for the cessation of claims against the country in crisis, together with interim financing from the IMF and a Fund-supervised voting process to determine the restructuring. The plan included the four elements discussed above: (i) standstills plus automatic stays to prevent a grab race; (ii) preferred-creditor incentives for the provision of new money by the private sector; (iii) conditionality on the part of the debtor to negotiate in good faith and adopt appropriate policies; and (iv) supermajority voting to bind minority creditors to a restructuring agreement. The standstill would be activated if a request by the debtor country was endorsed by the Fund and would be subject to renewal by the IMF up to a maximum period beyond which it could not be maintained without the approval of a required majority of creditors. Though the adjudication of disputes and the verification of claims were explicitly mentioned as areas outside its competence, "the Fund's role would be essential to the success of such a system." (Krueger 2001).

A key feature of the updated version presented at the Institute conference (SDRM-2) is that the role and power of creditors are considerably enhanced.

3. The recent case of Elliott Associates, which extracted full payment from Peru by threatening to interrupt payments on the restructured debt, was discussed in Krueger (2001 and 2002).
4. In the papers presented at the conference, isses of "debtor moral hazard" were emphasized by Michael Chamberlain (2002): while the interaction of debtor incentives with creditor coordination problems was analyzed by Ghosal and Miller (2002).

Besides approving the final restructuring agreement, it is they who would decide both the duration of the automatic stay and the granting of preferred creditor status to new private money provided after the stay, as indicated in table 1, where the asterisks show points of creditor control. The mechanism for exercising this control would be supermajority voting, but the required majority was not explicitly stated. (In response to questions, however, a figure "somewhere between two-thirds and 80-85 percent" was indicated.)

While collective action clauses also embody similar provisions for supermajority voting, the IMF found two major objections to exclusive reliance on collective action clauses, namely the problems of *aggregation* and of *transition* (Anne Krueger, 2002, 14). The former refers to the need to coordinate creditors across different classes—what the legal device of a cramdown is designed to achieve. The latter refers to the fact that if collective action clauses are only included in new issues, it will take many years before the stock of outstanding debt can be substantially restructured.

When John Taylor rose to speak in favor of the decentralized, market-based approach offered by these contracts, it was made clear that the US Treasury had given some thought to the problems of transition. To answer the objection that the current position is not much different from the line taken in the Rey Report of the G-10—to little effect—the US Treasury proposed adding substantial "carrots and sticks" as incentives to change.

The idea that court-ordered supervision is not essential for debt restructuring was seconded by Steven Schwarcz. In his presentation at the conference, he discussed his proposal for an international *legal convention*, with provisions for preferred creditor status and supermajority voting, but not for an automatic stay nor for a cramdown. Though it is a reformulation of Chapter 11 explicitly for sovereigns, the author emphasized that "contrary to assumptions made in the economic literature, the Convention would be largely self-executing and would not require supervision by a bankruptcy court," Schwarcz (2000, 183).

In this context, it is important to note that *debt restructuring need not necessarily involve a reduction in net present value.* A corporation filing for Chapter 11 protection does not have to be insolvent—it just has to be unable to service its current liabilities, including capital repayments due (i.e., the problem may be one of illiquidity). By implication, there is no reason why the triggering of sovereign debt restructuring need necessarily involve a decisive judgement as to the nature of the crisis. But the SDRM proposals coming from the IMF are explicitly restricted to cases of "unsustainable" sovereign debts (i.e., solvency crises—for handling liquidity crises, mention is made of collective action clauses.[5]) But because it is usually so difficult to distinguish between illiquidity and unsustainability under crisis conditions, this must count as a design weakness in the proposed mechanism.

Contractual Proposals

In advocating the path of limited reform, Barry Eichengreen, a long-term advocate of collective action clauses,[6] listed their benefits as follows:

- i. they entrust the restructuring process to the market
- ii. through majority voting, they limit collective action problems
- iii. they provide thresholds for litigation and de facto sharing clauses
- iv. they entail a de facto standstill provision

He acknowledged that there were drawbacks, involving problems of asset diversity and market take-up:

- i. they do not ensure coordination across different creditor groups
- ii. they would have to be made universal to prevent asset substitution
- iii. they do not address problem of domestic currency debts
- iv. they have not been widely adopted—the transition problem.

When John Taylor rose to speak in favor of the decentralized, market-based approach offered by these

5. "Collective action clauses can make a useful contribution to the resolution of debt problems, especially in cases of illiquidity where a smoothing-out of the debt service profile is required rather than a reduction in the net present value of the sovereign's overall obligations." Krueger (2002, 16).
6. See, for example, Eichengreen and Portes (1995).

contracts, he argued first that there should be *majority action clauses* (where bondholders holding, say, 75 percent of the principal could agree to a restructuring which would be binding on the minority). He also advocated the inclusion of *representation clauses* (describing the process through which creditors would come together during a restructuring) and *initiation clauses* (describing how a standstill would be put in place with an automatic stay, until restructuring discussions got under way). (See table 1, row 4.)

It was made clear that the US Treasury had given some thought to problems of transition. To answer the objection that the current position is not much different from the line taken in the Rey Report of the G-10—to little effect—the US Treasury proposed adding substantial "carrots and sticks" as incentives to change. Carrots could include lower interest rate charges (for countries with such clauses) when borrowing from the IMF; and further financial inducements to carry out bond swaps on the existing stock. As a stick, the insertion of such clauses could be made a precondition of seeking an IMF program. This may sound a powerful threat, but is it credible that the IMF could withhold assistance in a crisis on such a technicality?[7]

The alternative adopted by the radical reformers is to change the rules of the game to allow for systematic creditor bail-ins. If the bail-in is orderly, then it is credible for the IMF not to get financially involved. This is the logic behind the approach adopted by Anne Krueger where the IMF authorizes some form of payments suspension to be followed by an international debt workout.

To tackle problems of asset diversity, it was proposed that such clauses could be included in bank debt as well. As for problems of aggregation across creditor classes, it was proposed that disputes between creditors could be handled in an arbitration process provided for in the contracts themselves. The paper presented by Bartholomew, Stern, and Luizzi (2002) offered an ingenious two-step bond swap where the first step is a bond swap designed to achieve uniformity of claim, and the second step is the actual reconstruction. Has the private sector already found an elegant and workable solution to the thorny problem of aggregation? And, if so, will Argentina provide the acid test?

Subsequent to the meeting, the Institute for International Finance (IIF)—previously seen as the defenders of the status quo—has given explicit endorsement to the insertion of collective action clauses, as we report below. Their proposal for establishing a Private Sector Advisory Group might also be designed to address some of the aggregation issues left unresolved in the US Treasury's document.

Status Quo

What of the status quo, with unilateral standstills (backed perhaps by IMF lending into arrears) and bond swaps, as indicated in the last line of table 1? If there was any selection bias working against the "no reform" camp at the Institute for International Economics conference, there is no denying that in Nouriel Roubini, that camp found an eloquent spokesman. He counts himself among those who support the status quo, though his allegiance is explicitly based on a second-best argument, for he writes, "while ideally a "statutory approach" or a "contractual approach" would solve these collective action problems and thus be welcome institutional developments, they are both unlikely to emerge, for a complex set of political-economy issues," Roubini (2002). What he refers to as the status quo includes the mechanism of take-it-or-leave-it bond swaps used in Pakistan, Ukraine, Ecuador, and Russia, and also the exit consents[8] used in Ecuador. It even includes "creative variants of the status quo…[with] market-based orderly restructurings that reduce risks of litigation and/or free riding," see, for example the recent JPMorgan proposal by Bartholomew, Stern, and Luizzi (2002). So when Roubini speaks of the status quo it is hardly a situation of stasis: it is full of the creative legal inventions that the reformers are claiming will help their cause to succeed!

A more robust criticism of radical reform was offered by Jeremy Bulow (2002). In his paper to the Brookings Panel, he said bluntly, "An international bankruptcy court does not seem like a good idea. Put aside the issue of existing debt and assume it all

7. If not, might countries not have an added incentive to exclude such clauses as a (cheap) signal of commitment not to default?

8. The "exit consent" mechanism for debt restructuring analyzed by Buchheit and Gulati (2000), involves no change to the existing legal rights of creditors or debtors: the idea is that creditors willing to restructure can outmaneuver holdouts by using the supermajority voting features of existing bonds to secure changes, which reduce their value as they are tendered in exchange for restructured debt.

Box 1 The "time consistency trap"

The argument that reform of the architecture is necessary to save the IMF from what has been dubbed the "time consistency trap" (Miller and Zhang 2000) can be illustrated by a game tree that shows the order of play, as in figure 1.

In reality there are several players involved—including creditors, the sovereign borrower, and the IMF. To keep things simple, we treat them as two: the creditors and the debtor-plus-IMF. In the same spirit, we assume that *nature* determines whether or not there is a crisis. In the good state each of the two parties gets the highest payoff, α , but payoffs in the bad state when a financial crisis occurs depend on how the crisis is handled.

If the creditor *rolls over* the loan, for example, both parties get a payoff of β. If not, the solid lines indicate two very different prospects: a *bailout* ensures that the creditor still gets α, but the debtor only receives γ; but with *no action* both receive default payouts of δ. What will transpire is seen by working backward. At the second stage, the IMF chooses a *bailout* in order to avoid a default scenario. This is shown by the arrowhead on the left-hand branch of the two choices facing the IMF. Knowing this, the creditor fails to *rollover*, as shown by the arrowhead on the left-hand branch of the two choices facing the creditor. So there is no creditor involvement, just *bailouts*. (Two ways of escaping this trap indicated in the figure—*constructive ambiguity* and *bail-ins*—are discussed below.)

miraculously disappeared. Even so the myriad problems in determining who would judge such a court , what claims would be covered, and how the court's decisions would be enforced, make it seem a less desirable alternative than the current system."

Nor did the paper express any enthusiasm for the US Treasury's plan of pressing for the adoption of UK-style restructuring conventions. On the contrary, Bulow questioned "the extent to which we should allow outside enforcement technology, say the laws of the United States and Great Britain, to enable third world governments to borrow more than they could manage otherwise." His specific proposal—to "eliminate the sovereign immunity waivers that allow debtors and creditors to use first world courts to enforce third world agreements"—was much criticized by Nouriel Roubini, his discussant at the Brookings Panel, who characterized it as a device to "shut down or severely restrict the ability of "reckless" sovereign debtors to borrow internationally," Roubini (2002, 11-13).

Strategic Considerations: Keeping Your Options Open

Before looking at possible next steps in debt restructuring arrangements, it is worth standing back from the legal detail, in order to see some of strategic influences driving the debate.[9] This section suggests the value of keeping "statutory" change as a valid option, even while trying the path of "contractual" reform.

In the absence of reform (radical or otherwise), the IMF faces an unpalatable policy choice in dealing with a capital account crisis involving sovereign debt—to organize a wholesale "bailout" of the creditors, or to leave the emerging-market sovereign debtor to the uncertain fate of disorderly default. Looking at incentives as a strategic game between creditors and the IMF suggests that, in these circumstances, the latter may be "gamed" into providing "bailouts". This point has been made by both Stanley Fischer (2001), the outgoing first deputy managing director of the IMF, in his Lionel Robbins Lecture at the London School of Economics in October 2001, and by his successor Anne Krueger (2001), in the November speech quoted above.

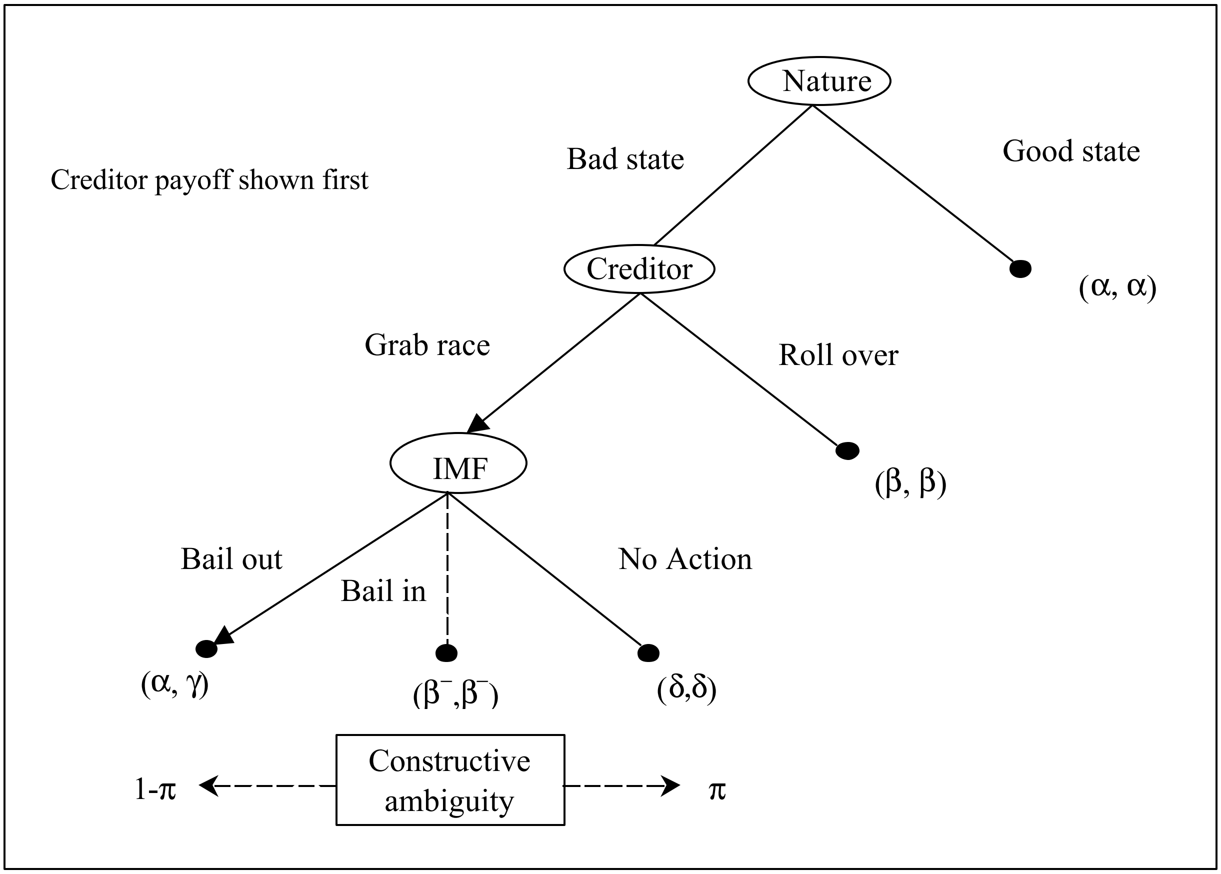
At first blush, the answer seems clear—the IMF should simply "say no" to bailouts—or "limit access" to financial support in this form, as was proposed by the Meltzer Commission, (IFIAC 2000), which recommended prequalification criteria for access. But this neglects the order of play, which gives creditors a first mover advantage as shown in box 1.

The argument is that, because they know that the IMF will step in to help the debtor pay them off, creditors have an incentive to make rash loans and then, when things go bad, to rush for the exit or to grab assets. In other words, the system is characterized by "investor's moral hazard."

If just saying no is not credible, how about saying no sometimes? That is, following a policy of *constructive ambiguity*, which makes bailouts less of a sure thing. The idea is that the risk of *not* being rescued gives the creditor the incentive to roll over debt—even if it involves some write-down—as this

9. Kumar and Miller (2000) contains further discussion.

Figure 1 The time consistency trap and two proposals



may be preferable to a disorderly default. So the private sector gets *bailed in*. In principle, this could do the job.[10] But there are practical pitfalls to this approach: first, there is the problem of stopping *free riders* who are unwilling to go along with any proposed write-downs; second, there is the objection that randomizing IMF rescues would fall afoul of the equal-treatment principle for IMF members; and third, there is the prediction that the denials of support will not be random. Market expectations will lead to a bifurcation of spreads reflecting the probability of default—with bailouts expected for countries of systemic importance ("too big to fail"), and defaults for the rest.

The alternative adopted by the radical reformers is to change the rules of the game to allow for systematic creditor *bail-ins*. If the bail-in is orderly, then it is credible for the IMF not to get financially involved, i.e., it should shield the IMF from being gamed into generous bailouts. This is, we believe, the logic behind the approach adopted by Anne Krueger (2001 and 2002) where the IMF authorizes some form of payments suspension to be followed by an international debt workout.[11]

The logic of those advocating limited reform is not so different. The need for bailouts will be reduced because of the availability of credible private sector provisions. As John Taylor put it: "Sovereign debt restructuring reform will go a long way to help limit official sector support." But what if—because of unsolved problems of aggregation and transition—recommending collective action clauses fails to work? Then the IMF will be exposed to gaming once more as it has been since 1996 when collective action clauses were first proposed in the Rey Report.

10. To continue with the example shown in box 1, if the IMF uses a mixed strategy, choosing no action with probability π and bailout with probability then this policy gives the creditor the incentive to roll over so long as the expected payoff is less than β (i.e. $(1-\pi)\alpha + \pi\,\delta < \beta$).

11. How this might change the game is shown in the figure, where the IMF now has another option labelled *bail-in*, with pay-offs shown as β^-, β^-, i.e. something less than under the *rollover*. Since the payoff for IMF-plus-debtor is greater than the default payoff, the creditor can no longer count on being bailed out. Faced instead with the prospect of a *bail-in*, the creditor has the incentive to choose a *rollover*.

Going back one step further, one has to ask what incentives creditors have to write the appropriate contracts, if the IMF only has bailouts on offer. John Taylor talked of sticks and carrots: the financial carrots may be helpful—but the real stick, we believe, is the threat of an IMF scheme for debt restructuring! A demonstrable benefit of the IMF devising statutory bail-ins lies in giving incentives to lawyers working for the private-sector creditors to produce their own solutions. Should the latter succeed in solving the problems of aggregation and of transition by ingenious combinations of one- and two-step bond swaps, with or without exit consents, they will earn their fees for engineering orderly workouts. Should they fail, it will be the turn of the lawyers working in the official sector to try their hand, armed with extra, statutory powers.

Next Steps

Although the IMF voiced two major reservations about relying exclusively on collective action clauses (the problems of aggregation and of transition), they have nevertheless expressed a willingness to support a strategy of seeing what these clauses can do. This is partly a question of timing: as Anne Krueger said in a press briefing, “let’s see what they can do because, of course, they could be put in faster.”[12] But it may also be a matter of strategy: as just mentioned, the market may be more willing to innovate under the threat of statutory intervention by the IMF.

What steps can now be taken? What incentives can be given to promote collective action clauses and travel the path of limited reform? We indicate half a dozen.

i. Following the lead of Canada and the United Kingdom, G-7 governments could insert collective action clauses into their own foreign currency debt. This should reduce the negative “signalling” currently associated with including such clauses in emerging-market bonds—and help overcome the hesitation of those acting only “après vous, Alphonse!”

ii. Providing financial incentives for emerging-market governments to include the relevant clauses in new debt—these could be in the form of interest rate reductions for borrowing from the IMF for those who do so and/or financial penalties for those who do not.

iii. Providing financial incentives to creditors to swap their existing debt instruments for those with the new clauses (using exit consents, if necessary); cf. the 5 percent cash incentive in the JPMorgan proposal (see Bartholomew, Stern, and Luizzi 2000).

iv. Promoting competition between London and New York in the provision of legal services necessary to achieve these changes—there are surely substantial fees to be earned.

v. Providing a venue for discussing the terms of sovereign debt restructuring, an issue that was raised by Michelle White (2002) in her paper to the conference.[13]

Subsequent to the conference, Charles Dallara of the IIF has, in a letter to Gordon Brown, chair of the International Monetary and Financial Committee, proposed that the IMF and the governments that form its membership set up a “Private Sector Advisory Group” that would offer its views on debt restructuring in specific countries to “sustain investor confidence and lay the basis for orderly restructurings.” Such a Bond Restructuring Forum might function like the Paris Club for bilateral debt or the London Club for bank debt. In table 2 we list possible venues in G-7 financial centers (and Switzerland)—including Washington, DC, itself. The idea would be to amass the expertise, legal and financial, necessary to handle cases as expeditiously as possible, so that, unlike Argentina, negotiators do not have to start from scratch. Perhaps the IMF could promote competition between these financial centers to host such a forum.

vi. Last, but by no means least, is further development of the statutory alternative along the lines of SDRM-2, both to provide an incentive for legal ingenuity in creating contracts, and to ensure a backstop if the latter should prove unable to solve the problems of aggregation and of transition.

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12. Transcript of a teleconference on Sovereign Debt Restructuring Mechanism, April 1, 2002.

13. Miller and Zhang (2000, 357) discuss the idea of a Basle Club and give references to other like proposals.

Table 2 Possible locations for a Bond Restructuring Forum

Country	City	Pro	Con	Comment
France	Paris	Neutral; home of Paris Club	Bad signalling effect?	Has Secretariat and good reputation for promptness
United Kingdom	London	Home of London Club; expertise on London debt		Has collective action clauses in foreign currency sovereign debt
United States	New York or Washing-ton, DC	Principal jurisdiction for emerging-market bonds; expertise on NY debt	Not "neutral"; not cheap.	New York bond terms are part of the problem! Washington, DC, is home of the IMF and US Treasury
Germany	Frankfurt	Neutral; large holders of emerging-market bonds	Legal system uses bond provisions like New York debt	
Japan	Tokyo	Neutral; large holders of emerging-market bonds	Neither govern-ment nor legal system renown-ed for debt restructuring	
Italy	Rome	Neutral		All roads lead there!
Canada	Toronto	Neutral; uses London debt; supports debt restructuring		Has collective action clauses in foreign currency sovereign debt
Switzer-land	Basle	Neutral; home of BIS, FSF		

Conclusion: A Two-Pronged Approach to Reform

After the resolution of the Latin American debt crisis of the 1980s, emerging markets enjoyed greatly increased access to global capital markets. For a while capital flowed freely and it seemed like the dawn of a brave new world, with emerging markets growing fast with the aid of substantial private development finance from the richer creditor nations. But it was not to last: there came a succession of "sudden stops,"[14] starting with the "tequila crisis" of 1994-95, with shattering consequences that have haunted emerging markets ever since. Few would dissent from John Taylor's view that "there have been too many crises, which have discouraged capital flows and damaged the affected economies."

The approach endorsed by the US Treasury to improve the functioning of global bond markets is to promote creditor self-organization by the insertion of collective action clauses into bond contracts in particular; and corporate bond markets offer historical evidence to support this approach. Such clauses had their origin in 19th century London capital markets suffering from frequent failures of creditor coordination and an excess of company liquidations. They were widely adopted so that all debt issued on

14. Guillermo Calvo's graphic phrase; see Calvo 2002.

London terms allows for restructuring. Recent experience in global markets has been very different. Soon after the Mexican crisis of 1994-95, the Rey Report commissioned by the G-10 recommended the adoption of such clauses, backed, if need be, by a policy of IMF "lending into arrears". But the dominant position of New York terms has remained unshaken. So, sovereign debt restructuring remains extremely difficult and uncertain.

The IMF has, in the circumstances, advocated a statutory approach. After a change in the Fund's Articles, this would allow a supermajority of creditors—acting under supervision of the IMF or some other arbitrator—to make a restructuring binding on holdouts. It is something of an irony that US corporate history provides a precedent for this approach. When firms were collapsing like ninepins in the Great Depression, Chapter 11 was added to the US Bankruptcy Code to release the stranglehold that unanimity imposed on the process of corporate debt restructuring. While accepting that reform is "long overdue", however, John Taylor has declined to endorse the IMF initiative. Wittingly or not, his intervention has demonstrated the blocking power of the holdout creditor. It takes a supermajority vote of 85 percent of IMF's shareholders to change the Articles; and the United States alone has more than 17 percent of the votes.

As the United States accepts that reform of the process of sovereign debt restructuring in emerging markets "is long overdue", it will doubtless do its best to ensure its preferred approach works—with financial and other incentives as discussed above. Should this approach fail to deliver, then—on the principle that he who wills the end wills the means—the United States will need to withdraw its blocking vote and support the IMF position. If not, it will be putting the latter in the unenviable position of being charged with managing crises but denied the tools needed for the purpose. Assuming that the clock is not to be turned back to the days of bigger and bigger bailouts, the IMF would, in all fairness, have to warn emerging-market debtors of the substantial risks and uncertainties to be faced should they ever be unable to service their debt—citing Argentina as a case in point.[15] They might be forced to recommend (or impose[16]) capital controls to limit risk exposure in global markets without restructuring provisions.

Such a stand-off between the IMF and its largest shareholder would be unfortunate, to say the least. It is also unnecessary, as strategic considerations suggest the two approaches are, in fact, complementary. Two developments support this conclusion: first, London has, despite the existence of collective action clauses, recently being trying to bring its corporate bankruptcy law more into line with US practice as enshrined in Chapter 11; and second, for reasons of aggregation, bond exchanges were used in Pakistan, despite the existence of collective action clauses.

More to the point, the IMF and the US Treasury have themselves noted this complementarity. In her Institute keynote address, for instance, Anne Krueger recommended collective action clauses for handling liquidity crisis—and in the press briefing she confirmed that the IMF was willing to see what collective action clauses can do, in part because they can be "put in faster" than statutory changes.[17] Subsequently Randal Quarles, assistant secretary for the US Treasury for international affairs, is reported as saying, "the two approaches are complementary; [they] aren't exclusive of one another. The Treasury approach is easier to start up quickly, while there's obviously more ramp-up time on the [IMF's] approach."[18]

The IMF has concluded that the process of sovereign debt restructuring in emerging markets badly needs reform and it has put forward a carefully revised plan of statutory change to ensure active creditor involvement in orderly workouts. The US endorsement of an explicitly contractual approach was widely interpreted as a rebuff.[19] But these two strategies can, we believe, be pursued in tandem. The private sector can, as Taylor proposes, be given every encouragement—with sticks and financial carrots—to incorporate collective action clauses into new sovereign debt contracts (including those swapped for currently existing debt so as to solve the transition problem). Meantime, the lawyers in the IMF can refine the scheme advanced by Anne Krueger so as to incorporate whatever the private sector devises, and to provide the "statutory" support necessary to tackle outstanding issues of intercreditor equity (the aggregation problem). The knowledge that this parallel effort is in motion should give added incentives for private sector ingenuity at the contractual stage. Orderly restructuring procedures are more likely to be developed using this two-pronged strategy of reform than from either approach in isolation.

15. Where it is rumoured that the restructured debt will have to contain collective action clauses.

16. Karin Lissakers, ex-US executive director at the IMF, argued at the Institute conference that the IMF had the authority under Article 6 to ask a country to impose capital controls; and that it should do so in times of financial crisis "to trigger the restructuring and stop the bleeding of money in the meantime."

17. Transcript of a Teleconference on Sovereign Debt Restructuring Mechanism, April 1, 2002.

18. *Washington Post*, April 9, 2002, E4.

19. See, for example, the report in the *Economist* (Economics Focus, April 6, 2002, 67), "Sovereign bankruptcies: Two Bush appointees are at loggerheads about how to reform the international financial system."

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