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How to Resolve Sovereign Debt Crises in the Twenty-First Century

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Debt Restructuring and Sovereign Bankruptcy

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HOW TO RESOLVE SOVEREIGN DEBT CRISES IN THE TWENTY-FIRST CENTURY

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Barry Herman¹

A piece of the international financial architecture is missing, one that would facilitate more effective, fair and timely sovereign debt workouts than the ad hoc, inconsistent and sometimes highly political processes that are applied today. While a newly created mechanism should be available to any sovereign government, including in Europe, special concerns have been voiced, as in the convoking of this conference, for improving debt workouts in low and middle-income countries, where crisis-related declines in living standards that are part and parcel of sovereign debt crises are hardest to bear. The desirability of having such a mechanism was globally agreed by heads of state and their finance and foreign ministers at the Monterrey Summit on Financing for Development in 2002,² and serious discussions about creating such a mechanism took place at the International Monetary Fund (IMF) in 2002-3, albeit without reaching agreement. It was not the first time that the matter was addressed internationally. Efforts were made to create international debt workout mechanisms in 1907 (Hague Convention), 1933 (Montevideo Pan American Conference), 1942 (early stages of Bretton Woods), 1978 (UNCTAD agreed guidelines), 1996 (HIPC for poorest countries), as well as the IMF initiative in 2002-3 (SDRM).³ If a permanent global instrument has not yet been created, can it still happen? Yes, global institutional changes do happen, albeit only when the conditions are ripe. This paper argues that launching an initiative at this time would be opportune.

The ensuing discussion first suggests that while the developing country debt

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² “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” (United Nations, 2002, paragraph. 60)

³ On the Hague Convention to arbitrate sovereign debt crises instead of using force to resolve them, see Scott (1909, chapter VIII); on the Montevideo Conference and early Bretton Woods drafts, see Helleiner (2008); on the guidelines adopted in the United Nations Conference on Trade and Development and the Heavily Indebted Poor Countries Initiative, see Cosío-Pascal (2010, pp. 240-241 and 248-51); and on the proposed Sovereign Debt Restructuring Mechanism at the International Monetary Fund, see Setser (2010).

situation is no longer making headlines, it is a good time to consider creating a mechanism for use when the situation becomes less benign. It then reviews the existing mechanisms for sovereign debt workouts and the limited contributions made (and feasible) from voluntary codes of good conduct, and thus why it is appropriate to think about creation of a new mechanism. It goes on to describe the characteristics that an appropriate sovereign debt workout mechanism should have. It should be a single mechanism, available to all countries, albeit with different configurations of creditors engaging in workouts for lowest-income than for other countries. The paper concludes by arguing that there are not only economic systemic and fairness reasons, but also political ones, for launching a new debt policy initiative now.

The current situation

At the time of writing this paper, there has been great effort in the European Union to treat the sovereign debt difficulties in several countries as liquidity problems that can be addressed with official financing and domestic policy adjustments and no restructuring of the debt or even postponing of the debt servicing. Financial markets have, till now, not been convinced, judging by the high yields on the bonds of the affected countries. However, in contrast to the unfolding European drama, this is a period of relative calm as regards developing country debt, despite the recent stresses of the global financial and economic situation. Only five countries are currently in “debt distress” meaning they are not fully meeting their debt-servicing obligations (see box).⁴ However, the IMF and World Bank classified 15 countries as at “high risk” of debt distress and 24 countries at “moderate risk,” which is an indicator of vulnerability should the world economy experience another major economic or financial shock, or should the countries suffer a natural calamity or other major external shock. Indeed, several of the countries listed in the box are elsewhere classified as “small vulnerable economies” (Commonwealth Secretariat, 2010).

On the one hand, in other words, it is not expected that the fiscal and financial strains even in the “high risk” countries will reach the crisis point in the near term. On the other hand, developing countries have been urged, as by IMF, to rebuild the “macroeconomic policy buffers” that they drew upon during the recent crisis to be able to defend themselves again against potential future shocks (IMF 2010b). Defaults cannot be ruled out, especially when one cannot rule out new natural calamities, linked for example to climate change, let alone terms-of-trade shocks, as stemming from international food and fuel price volatility (and especially rising cost of oil and food in the recent months), nor what impact a spreading European debt crisis, should it explode on the scene, might have on the world economy. The essence of economic catastrophes is that most economic actors do not expect them. Indeed, the short-term outlook for developing countries, including the least developed countries, is currently quite encouraging, though uncertainties over the evolution of the international economy remain very high.⁵

⁴ Including the four countries in the box and Côte d’Ivoire, which had been defined as “high risk”, but is actually in “debt distress”, as it defaulted on a \$2.3 billion Eurobond in February 2011, albeit in the midst of the violent succession struggle following its presidential election (*Africa Research Bulletin*, vol. 48, No. 1 (Jan 15-Feb 15, 2011), p. 18974).

⁵ For example, the United Nations Secretariat June 2011 forecast is that developing economies will grow 6.2% in 2011 and 2012, while least developed countries are forecast to grow by 5.6% and 5.8% respectively in those years (United Nations, 2011).

Another characteristic of the current situation is that there is widespread acceptance – at least outside the financial industry itself – of the need for systemic reform of the international financial architecture. The proposals that have been debated intensively since 2008 are meant to moderate some aspects of the volatility and generally reduce vulnerability to financial crises. They also address mechanisms for financial institution rescues from financial crises, which bear on risks of sovereign insolvency, as governments have no choice but to act to keep their financial systems functioning and thus in one way or another take over private financial sector obligations. And yet, actual international policy reforms have been relatively limited or slated for delayed implementation, and governments are again largely on their own to build their policy “buffers,” as noted above. Indeed, because there is much legitimate concern with the potential volatility of international financial flows, governments of several emerging economies have introduced controls on capital movements.⁶ Some years ago, such policies would have been considered an unacceptable distortion of efficient financial markets, which are now deemed less efficient and potentially dangerous. By the same token, arguments for “market-based solutions” to sovereign debt crises should be reexamined.

In other words, owing to the extensive commercial bank holdings of sovereign debts and the reality that banking systems are contingent liabilities of governments, appropriate resolution of sovereign debt crises is of systemic importance to the national economy of every sovereign, including low and lower middle-income countries, especially where governments have issued increasing amounts of domestic debt in recent years that is held by local and foreign financial institutions. If a debtor country is large and its debts are held around the world, or if a crisis in one country spreads to other countries deemed in the same “asset class”, the global financial system itself may be endangered. Today, there is a concrete concern of this latter type in Europe.

Entering today into a new debt reform initiative could be of assistance in resolving current crises in Europe.⁷ However, given inevitable lags in developing and implementing a new mechanism, it would more likely be applied in the next wave of country difficulties. The point is to have that mechanism available when countries need it and for the financial markets and official creditors to know ahead of time what the “rules of the game” will be. The proposal is thus to add a sovereign debt workout mechanism to the menu of essential systemic reforms.⁸

⁶ Brazil, Indonesia, Republic of Korea, Peru, Taiwan Province of China and Thailand together introduced 14 policy measures to discourage capital inflows from November 2009 to the present (United Nations, 2011, p. 6).

⁷ For example, even though most of Greece’s debt has been issued under domestic law and thus can be restructured under that law, Greece has felt politically unable to act unilaterally. Thus, while the legal challenges of addressing domestic and external debt may differ, an international sovereign debt mechanism can have strong political value in reaching a comprehensive workout (appreciation to Shari Spiegel for this observation).

⁸ This is the context as well the same spirit as the proposal of the “Stiglitz Commission” (United Nations, 2009, pp. 121-5). See also Griffith-Jones and Ocampo (2010)

Box. Countries currently identified as at risk of debt distress

Under the joint IMF and World Bank Debt Sustainability Framework for low-income countries, explicit assessments are made of country exposure to the risk of a sovereign debt crisis. The assessment is not made for all countries but for 72 countries that qualify to draw from the IMF's special concessional lending facility, the Poverty Reduction and Growth Trust (IMF, 2010). The assessment is meant to help inform official donors whether it is advisable to extend further assistance in the form of grants as opposed to loans that, however concessional, increase the receiving country's stock of outstanding debt. It is also meant to help governments manage their debt and fiscal situations. It is understood to be a rough measure (less nuanced than bond-rating agency assessments, the latter of which are also highly imperfect), and not an unconditional forecast, serving rather as a basis for policy discussions.

There are four classifications in the debt sustainability analyses (DSA). Countries are classified as being "in debt distress" if they are presently not meeting all their external debt-servicing obligations. All other classifications refer to the findings of the most recent country DSA (in the listing below, almost all were undertaken in 2010 or 2011). The assessments are in terms of whether projected values of specific debt or debt service indicators exceed common trigger values, themselves a function of a separate evaluation by the World Bank Staff of the quality of the country's policies and institutions. Countries judged to have "weak" policies and institutions are expected to face repayment problems at lower debt indicator levels than countries with "strong" policies and institutions. Countries are classified as at "high risk" if the "baseline" scenario for the next 20 years as calculated for each country shows a "protracted breach" of the relevant thresholds. Importantly, however, high-risk countries are currently fully servicing their debt. Countries are classified as at "moderate risk" if their debt indicators over 20 years are below the thresholds in the baseline scenario, but they exceed them in an "alternative" scenario, signaling vulnerability to "external shocks or abrupt changes in macroeconomic policies" (IMF 2011). Countries are classified as "low risk" if both baseline and alternative scenarios are well below the threshold levels.

Based on the country listing of assessments as of May 15, 2011, 4 countries were classified as in debt distress, 15 as having "high risk" and 24 others as at moderate risk, as follows:

In debt distress: Comoros, Guinea, Sudan, and Zimbabwe

At high risk: Afghanistan, Burkina Faso, Burundi, Côte d'Ivoire,* Democratic Republic of Congo, Djibouti, The Gambia, Grenada, Guinea-Bissau, Haiti, Lao Peoples Democratic Republic, São Tomé and Príncipe, Tajikistan, Tonga, and Republic of Yemen

At moderate risk: Benin, Bhutan, Cambodia, Central African Republic, Chad, Republic of Congo, Dominica, Georgia, Ghana, Guyana, Kyrgyz Republic, Lesotho, Malawi, Maldives, Mauritania, Nepal, Nicaragua, Papua New Guinea, Rwanda, Sierra Leone, Solomon Islands, St. Lucia, St. Vincent and the Grenadines, and Togo

* Côte d'Ivoire could be reclassified as in debt distress as it defaulted on its Eurobond during the disputed post-election transfer of power (see text footnote), a highly unusual and probably temporary situation.

Inferiority of the existing system

In a typical case of corporate insolvency, the debtor seeks “protection” from its creditors in a special bankruptcy court. The bankrupt firm will not have enough assets that can be liquidated to pay off the firm’s outstanding obligations and the creditors thus have a collective interest in the court overseeing an orderly and comprehensive bankruptcy workout either to wind up the firm and share what assets it does have with the creditors according to the seniority of their claims or to refloat the firm if it is deemed viable after reducing its debt to a level that is believed sustainable, with creditor losses again apportioned in light of seniority. Neither owners nor managers seek bankruptcy protection lightly. Shareholders usually lose their entire stake in the firm and senior managers are typically fired; workers lose their jobs and possibly their pensions. Individual creditors might at first prefer to rush to court to press their individual claims, but very quickly that becomes untenable as the claims are too large. Moreover, in the interests of the creditors and other stakeholders in the firm (including the tax authorities), the bankruptcy court will act to at least temporarily preserve what they can of the firm, for example, preventing asset stripping by management. If the firm is to be rescued, the court oversees the early stages of the recovery process, until the firm “emerges from bankruptcy protection.” Importantly, while the court operates so as to maximize recovery of creditor assets, it is independent of the creditors and is guided by laws, principles of justice and the national interest, the latter especially germane when an economically important firm is at stake.

None of this applies to a case of sovereign insolvency (Kargman, 2005). There is no international court in which a government can seek protection from its foreign creditors. There is also no court in the country of the creditors that can force a foreign government to repay its loans (at least as long as the government has moved its “commercial” assets out of the reach of governments that might seek to enforce a judgment made in its court system; “diplomatic” assets cannot be impounded). Instead, the debtor government informs its private and official creditors that it cannot make payments falling due and seeks assistance in correcting its fiscal imbalances, usually in an adjustment program with the IMF, which also makes loans to the country provided it meets the policy conditions the IMF requires. From that point on, decisions are made by creditors or international institutions controlled by creditor governments, in varying degrees of negotiation with the debtor government. The exceptions involve important debtor governments that can push back by taking unilateral action, such as Argentina and the Russian Federation, or that strike when the creditors and their governments are otherwise preoccupied, as in Ecuador in 2009 (see below).

The sovereign debt workout process is thus an informal arrangement among interested parties, unlike under a bankruptcy court. Informal arrangements happen as well in corporate insolvencies of the relief and rescue mode. However, there are two essential differences in the corporate case. One is that the parties are working “in the shadow” of the bankruptcy law, meaning that if the voluntary process fails the formal (and more expensive) bankruptcy process will be invoked. They may thus voluntarily negotiate toward a solution that is similar to that of the court. The other major difference is that the public interest in the outcome of the corporate case is generally less intense than in the sovereign one, where serious deterioration in the wellbeing of a broad swath of the population hinges on the degree to which they bear the burden of the workout. In other words, there is a deep political and humanitarian interest in how

much sacrifice is made and by which population strata in mobilizing the fiscal resources for post-workout debt servicing.

As most governments have a substantial number of creditors, groups of creditors have organized themselves to protect their interests. In the case of creditors of low-income countries, most of the sovereign debts are loans from other governments (including export credits extended by banks but taken over by official agencies that had guaranteed those debts when the debtor defaults), and multilateral institutions. The debt workout thus involves arrangements among governments, with bilateral creditors typically represented by the informal Paris Club, which establishes common principles for fair burden sharing among its members and, as they are creditors, seeks to minimize the relief given to the debtor.⁹ In strategically important cases, the standard rules are not followed and greater relief is given. In politically important cases of a different sort, in particular, for the countries that were the focus of the massive global “Jubilee Campaign” to deepen debt reductions of the poorest and most heavily indebted countries in the world, the Paris Club agreed to increasingly deeper relief. Multilateral debt obligations were reduced through donor contributions and use of profits of the institutions in separate initiatives (Cosío-Pascal, 2010).

The Paris Club has also sought to take a leading role in determining the amount of relief for countries that are not in the special category of Heavily Indebted Poor Countries (HIPCs), or that require assistance after successfully exiting the HIPC process. However, in seeking to apply its “Evian Principles,” the Club has to rely on the goodwill of private creditors, which often have much larger exposure to the debtor country than the Paris Club creditors, as well as that of non-Paris Club official creditors, as from Middle-Eastern and emerging market countries. Indeed, either the Paris Club widens its membership to include the rising non-member official creditors or it will see its influence significantly diminish.

In fact, private creditors have no obligation to offer “comparable treatment” to that of the Paris Club creditors (although the debtor government is obligated to seek it) and in most cases they do not look to Paris for leadership in this regard. Since the 1980s, commercial bank creditors have organized their negotiations with sovereigns in crisis through informal and ad hoc groups called “London Clubs” or bank steering committees. Bondholders, now the dominant source of private credit, organize themselves according to the arrangements in the contracts of the individual bond series.¹⁰

⁹ This is not to say that Paris Club negotiators are not concerned with the social and economic cost of servicing debt for developing countries; only that they represent the interests of creditor agencies, albeit sometimes tempered by the interests of the development cooperation ministry.

¹⁰ Ten years ago there was a great discussion over proposals to modify the terms of sovereign bond contracts issued under the laws of New York State and certain other jurisdictions. That debate over so-called “collective action clauses” (CACs) would have (and have) made the contracts more similar to those issued under the laws of the United Kingdom, in particular specifying what super majority would be needed to change the financial terms of the bond, hence effect its restructuring as part of a debt-crisis workout. The fear was that holdout creditors could disrupt a restructuring that most bondholders were willing to accept, as New York law bonds required unanimity to change these terms (but not other terms). In fact, lawyers for the debtor governments had devised a strategy to overcome this problem, known as “exit consents.” Moreover, there is strong reason to believe the whole effort was largely a tactic by the financial industry to kill the IMF’s proposed SDRM, which it helped to do (see Gelper and Gulati, 2010). Nevertheless, this experience shows that more radical proposals, like SDRM, can help

There are thus potentially several different creditor groups spread around the world, some only loosely organized, with which the debtor needs to settle. In practice, the debtor government consults with its various creditor groups in seeking the best overall package it can obtain given its usually poor bargaining position.

In this context, IMF – working closely with the World Bank in low-income country cases – plays a central role in assessing how much relief is deemed warranted, as well as the amount of new loan and grant financing to extend to the debtor country during its economic adjustment period. Neither Paris Club nor private creditors nor the debtor government need base their debt restructuring negotiations on the IMF assessment, but it does de facto serve as a benchmark. In this regard, IMF formally represents the global public interest, although its governance structure gives effective control to the creditor governments and it is perpetually criticized by global civil society organizations for having a pro-creditor bias and tolerating deep social distress in debt-crisis countries.

Except in the case of the HIPCs, where the Fund and Bank take the lead, the debtor government coordinates its own debt workout. It may seek a “cooperative” workout with major groups of creditors or adopt “unilateral” strategies to seek a better outcome from its perspective, for example sequencing the order of creditor classes with which it negotiates, demanding smaller concessions from the creditor groups with which it needs to settle first.¹¹ The process can also be quite drawn out. As of May 2011, Argentina had still not settled with the Paris Club on the official creditor part of its 2001 default (although discussions were underway), and it took seemingly endless rounds of debt workouts for low-income countries both before and during the HIPC era.¹²

The private creditor community has argued that it is in the interest of sovereign borrowers to develop a cooperative relationship with its creditors during good times to draw upon in bad times. Moreover, it is said that confident creditors would lend more and on easier terms to debtors that built a transparent relationship of trust. Codes of good conduct have been proposed to delineate the cooperative relationship, a key feature of which is frequent government communication of information and policy intentions to its creditors. The most prominent code, which is advocated by the Institute of International Finance (IIF), an international association of the world’s major banks (which also acts as a lobbying group for their interests), holds out a promise that a debtor with a history of cooperation in good times and that makes credible pledges of adjustment policy reforms when times turn bad will be able to tap private bank funds even during a period of debt distress and will more quickly return to general financial market access after having been excluded during the depths of its crisis. However, these benefits of transparency are a forecast, not a commitment. Meanwhile, the debtor government is asked to commit to its part of the code. In this and other ways, critics have found this code biased towards creditor interests (Herman 2010). Other codes, as developed by civil society organizations, are more balanced, paying greater attention,

speed adoption of useful if limited change (collective action clauses) that was previously seen as unnecessary and risky.

¹¹ See Damill, Frenkel and Rapetti (2010) for the case of Argentina after 2001 and Gorbunov (2010) for the Russian workout at the end of the 1990s.

¹² For the case of Ethiopia’s 12 years of Paris Club debt renegotiation between 1992 and 2004, followed by the 2005 unilateral Multilateral Debt Relief Initiative and the country’s arrangements with non-Paris Club creditors up to the end of 2006, see Martin (2010).

for example, to the social impact of the crisis and its workout (Afrodad, 2011).

The most positive aspect of the codes is the call to share information, which should be with all stakeholders, not just creditors, and transparency should apply not only to the government but also to the major creditors, such as on their gross and net exposure to the debtor.¹³ While these general principles of openness make good economic sense for reducing uncertainty when making public and private decisions, they may not make good financial sense for any of the parties trying to negotiate a debt workout deal. Thus, one must expect selective information disclosure by governments, especially during periods leading up to debt crises, and quite limited voluntary disclosure of exposure by negotiating creditors (for example on whether they had hedged their position with credit default swaps).

Be that as it may, it is not even clear that cooperating with one's creditors in a crisis gives the best return to the debtor. Indeed, the people of Iceland recently voted to overturn their government's commitment to repay the British and Dutch governments, which covered Icelandic bank obligations to depositors from their countries. The unwillingness of Icelanders to pay seems very much tied to their sense of unfairness in the debt workout to which their government agreed. If the British and Dutch governments cannot overturn the decision through a European court, the uncooperative Icelandic taxpayers will have improved their workout at the expense of British and Dutch taxpayers.

Moreover, Ecuador demonstrated in its unilateral December 2008 default on a set of bonds that a hostile approach to its creditors can pay high dividends, in this case a 65% reduction of the debt (Buchheit and Gulati, 2009). It probably did not hurt that Ecuador's default came during the depths of the global financial crisis when eyes were elsewhere and that there had been popular domestic support for debt reduction, in part owing to a government-supported "audit" of the country's debt stock that found much of it to be "illegitimate" (Salmon, 2009 and link to article on the audit). Ecuador thus challenged the notion that countries never default voluntarily; the current government defaulted on bonds issued by a previous government on the ostensible grounds that there were problems with how and why the bonds were issued, but in fact it defaulted selectively and strategically at a moment of market opportunity (Porzecanski, 2010).

If Iceland showed there are limits to public tolerance at being squeezed by financial interests (here in the form of foreign governments that chose to bail out their citizen depositors in failed Icelandic banks), Ecuador showed that a small debtor could game a system whose rules had been stacked in favor of the creditors. Iceland's challenge was at inter-governmental level. Ecuador rattled the emerging markets financial community on Wall Street. As Hans Humes, head of Greylock Capital Management, a major investor in emerging market debt, was quoted as saying, "As much as we can say this is an outlier, any country which runs into trouble has a great blueprint now of how to do it... Maybe [the solution is to] go back to Anne Krueger's

¹³ Considerable data are already routinely published on country exposures of banks reporting to the Bank for International Settlements, with a one quarter lag; similarly, consolidated debt statistics including obligations to multilateral and bilateral creditors are jointly compiled (and compared) by four major international organizations on the Joint External Debt Hub (www.jedh.org). Nevertheless, data are more complete for some countries than others and in any case it is only during a crisis when creditors step forward with their claims (which must be vetted) that a full picture appears even in countries with efficient debt management offices.

model...If you're going to capitulate to Ecuador, then capitulating to the IMF is easy in comparison" (Salmon, 2009). This is definitely a minority opinion in the financial world, the preferred model being the creditor-dominated "cooperative" relationship. But, it could be a straw in the wind about the reliability of the creditor-led model.

Characteristics of a superior system

"Krueger's model," as referenced above, was the Sovereign Debt Restructuring Mechanism (SDRM) proposed and rejected at IMF. While creating a bankruptcy type procedure under IMF auspices remains a highly controversial proposal, the point to take away is that it might be time for the international community to consider creating some international mechanism whose normal operations would be judged fair to debtors and creditors, that would be timely and efficient to operate, and that would create stronger *ex ante* incentives for appropriate borrowing and lending behavior.

A sovereign debt workout mechanism would improve global economic and financial functioning, both in terms of financial sector operations and as regards development. Creating a sovereign debt workout mechanism is part and parcel of the systemic need to preserve a country's banking system, let alone deliver a fair deal to the country's citizens. Banks are traditionally major holders of sovereign debt and would have to absorb substantial losses from a sovereign default. This is said to be a concern today in Europe regarding the potential default of Greece, as it was in 2001 in Argentina during its default (Damill, Frenkel and Rapetti, 2010). But, not only can sovereign default trigger a banking crisis, a banking crisis can also create a sovereign debt crisis, as seen when the Icelandic and Irish governments took over the obligations of their failed banks, suddenly creating unsustainable sovereign debt levels for the countries. Indeed, concern does not lie exclusively in the financial sector, although bank takeovers are particularly common and costly. It is also not unusual for developing country governments to take over financial obligations of large non-bank investments that fail, even if it raises their sovereign debt to an uncomfortable level.¹⁴

Many developing countries, it should be said, have significantly strengthened their domestic financial sectors and bolstered sovereign debt management, as well as significantly increased their foreign exchange reserves, and thus may seem less at risk of systemic difficulties that would cause or result from a sovereign insolvency. However, assessments might change. Two of the strongest economies on earth have been rocked by unforeseen catastrophes: the bursting of the speculative financial bubble in the United States (a man-made catastrophe) and the Japanese earthquake, tsunami and nuclear meltdown. Imagine these events happening in less robust economies.

All in all, establishing a permanent sovereign debt workout mechanism would be a valuable international public good. It would remove one source of uncertainty impacting financial flows, as it would make clear what the process of debt crisis

¹⁴ If the 2009 actions of Dubai in rescuing "Dubai World" only temporarily shook confidence in the Emirate's debt sustainability, the 1999 takeover of "Ottley Hall" by the government of St. Vincent and the Grenadines did imperil that small country's debt situation. Ottley Hall was a joint shipyard venture between St. Vincent's government and a group of private investors that failed in 1999, when the government took over responsibility for its debts, mainly owed to a group of Italian banks; in 2001 the government defaulted on the debts, wherein the Italian government took them over as guarantor and in 2007 wrote them off (Herman, 2010a, p. 9).

resolution would entail should it become necessary. It would set standards for what constitutes an effective, timely and fair resolution of sovereign insolvencies. And to the degree that it made clear to creditors that they bore actual risks of non-payment or partial payment or delayed payment under particular circumstances, it would discourage lending into excessively risky circumstances. Risk-reducing improvements of this sort are in the global public interest, if not in the immediate interest of the stressed government that is essentially postponing its “day of reckoning.” It would thus lessen highly speculative and expensive short-term lending to countries with uncertain policies, direct more of international financial flows into capital formation in less risky countries, and strengthen the incentive for sound fiscal management. The payoff would be higher economic growth of developing countries, which is a prerequisite for sustainably reducing poverty, and possibly contribute to global aggregate demand.

There are numerous proposals for what the institutional structure of a sovereign debt workout mechanism should look like, which need not be reviewed here (but see Kaiser, 2010). The actual shape of such a mechanism would best emerge from multi-stakeholder discussions in an appropriate international forum, building toward consensus, and then inter-state negotiations to create the precise mechanism, which should thereby enjoy broad international “ownership.” One may nevertheless envisage key features of how such a mechanism should function.¹⁵

First, the objective of the debt workout should be essentially the same “fresh start” that corporations are deemed to be given when they emerge from bankruptcy protection (Stiglitz, 2010). This requires that all the debt obligations of the government be addressed together in one comprehensive debt workout plan, which would leave the government with a debt level and scheduled debt servicing obligations over time that it is expected to be able to meet without further negotiated adjustment. There can be no guarantee that the government will not fall back into insolvency, but the prospects should be good for not doing so. Moreover, the degree of expenditure tightening to accommodate post-workout debt servicing should be limited so as to protect and possibly even increase essential government functions, not least social services for the poor. Efforts would also have to be made to protect legislated and contractual commitments to citizens, as for pensions. Furthermore, priority development investment, e.g., in infrastructure, should be protected.¹⁶

Second, it is not clear how much more precise the guidance for the overall terms of the workout can be. The goal under the HIPC Initiative was that countries emerge from the program with a “sustainable” debt situation. However, it proved difficult to translate the concept into specific target levels of debt and debt servicing, as the initial targets first had to be interpreted for actual cases;¹⁷ then the targets were “enhanced” under a broad policy change; and finally they were rendered moot by the Multilateral Debt Relief Initiative (MDRI) which forgave all multilateral obligations of affected countries that had been incurred before one or another fixed date (Cosío-Pascal, 2010, pp. 248-251; Martin, 2010, pp. 283-293). With this experience in view, it seems best

¹⁵ The ensuing is based on the concluding chapter of Herman, Ocampo and Spiegel (2010), except as otherwise noted.

¹⁶ As envisaged here, guidelines developed for the workout mechanism would supersede the provisions in bond and loan indentures, putting the proposal here in the category of “statutory” as opposed to “market-based” (or contract-based) debt workouts.

¹⁷ For example, in a target ratio of debt to exports, exports of which year or years or who’s forecast of future exports (and whether baseline or alternative scenario) should be in the denominator?

that the international overseers responsible for a specific debt workout should apply approved general principles and otherwise build up precedents from actual cases, much as occurs in bankruptcy courts.

Third, it is appropriate that all relevant stakeholders be heard when the process of shaping the workout is underway. This, of course, includes the different classes of creditors, who may be expected to form themselves into groups for negotiation, including one or more groups of bondholders, banks, Paris Club, etc. They would formally participate as parties to the workout. By the same token, representatives of the people in the country would participate as affected parties, including the executive and legislative branches of the debtor government. Indeed, civil society representatives, trade unions and business representatives that fear particularly harsh impacts should also be heard. Consultation of the workout mechanism with all of these stakeholders should be in the open and accessible to press coverage, while appreciating that some aspects of any negotiation or judicial or arbitral process necessarily takes place behind closed doors.¹⁸

Fourth, as the aim of the exercise is to adjust the overall debt level and future debt-servicing profile, it is necessary for the workout mechanism to allocate the debt and debt-service adjustments to the various classes of creditors. While the workout overseer would be responsible for making concrete decisions (or accepting those agreed in a side negotiation by the involved parties), he or she should work under internationally approved general guidance. For example, the informal practice is to treat multilateral financial institution claims as senior to those of all other non-collateralized credits. This might be internationally endorsed, albeit with the proviso that these institutions might have to absorb losses if the debtor's prospects were sufficiently poor, i.e., senior but not inviolate.¹⁹ Other guidelines on repayment seniority in a sovereign debt workout could be specified. For example, seniority of private claims might be differentiated according to the age of the claim, as the current approach gives creditors who lend when default is approaching the same probability of repayment as lenders in pre-crisis times, diluting the claims of the previous lenders. Giving recent lenders lower priority might not only raise the degree of recovery on loans extended for sound reasons (and thus lower the risk premium on such loans), but also discourage pointless last-minute surges in borrowing before default (Bolton and Skeel, 2010, pp. 458-461). On the other hand, loans made after default and under the bankruptcy regime, on the model of "debtor-in-possession" (DIP) financing in corporate debt restructurings, whether extended by IMF, other public institutions or private banks, could be made senior to all other credits, even multilateral ones. Moreover, when governments temporarily nationalize their banking systems or corporations during a financial crisis, which then creates a sovereign debt crisis, the obligations arising from the bankrupt entities that thereby become government obligations should be dealt with separately from loans that originated as normal sovereign-risk credits.

Fifth, not only should the workout determine the total amount of debt and debt-

¹⁸ There should be provision for appeal of a disappointed minority to a second judge or panel of judges, on the basis of minority rights, although the cause for such appeal would have to be spelled out and not be able to undo the normal "cram down" of a bankruptcy treatment.

¹⁹ The requirement under the HIPC Initiative that international financial institution (IFI) losses had to be covered with other sources of funds, making relief contingent on success in mobilizing donors, should also be dropped as unfair to the debtor in crisis; if IFIs need to hold larger loan-loss reserves, so be it, as they would still need to hold less than commercial institutions.

service restructuring, but it should seek a relatively quick implementation schedule, so as to remove uncertainty about the adjustment path envisaged for the country. At the same time, any accompanying package of new financing to help the country during the adjustment period should quickly be agreed in parallel with the workout program. As in current practice, IMF would presumably play a major role here, jointly with the World Bank in the case of low-income countries, both in providing and mobilizing other official transitional financing. If seniority were accorded to DIP financing, as noted above, private funds for the adjustment period might also be mobilized.

Sixth, as in corporate bankruptcy, from the moment the insolvency process is invoked until the country emerges from it, the government should be protected from creditor actions in national courts. That is, individual creditors should not be able to recover their loans at the expense of others. Only a comprehensive workout would be permitted. It could begin with attempted mediation, with some form of arbitration available if progress is insufficient in the mediation phase.

Seventh, the remaining question is who invokes the insolvency mechanism. In bankruptcy, it is commonly the debtor, which acknowledges its inability to make a coming payment. One unfortunate consequence at the sovereign level is that since bankruptcy is taken as a sign of failure, political authorities seem to delay that moment as long as possible, building up debt levels unnecessarily and reducing the recovery of all creditors (at least under existing seniority rules, as noted above). For precisely such reasons, insolvencies of commercial banks are handled differently, as in the United States, where the government insures bank deposits and thus has a strong interest in stopping the mushrooming of unpayable bank liabilities. In this case, the government decides when to put the bank into “receivership,” an intriguing but politically impossible model for insolvent sovereign governments.²⁰

The political case for reform

As in all things political, the obstacle to creating such a workout mechanism has been the opposition of powerful actors: creditors have power – being either governments themselves or private creditors who enjoy the support of their governments. Private creditors have also been supported by the authorities of their largest sovereign customers, whose opposition to systemic reform would stem from concern about its impact on access to new loans or loans on more onerous terms.²¹ As a

²⁰ As a US bank’s situation deteriorates, the Federal Deposit Insurance Corporation (FDIC) would at some point grow concerned and issue warnings to the bank, try to locate a prospective merger partner and as a last resort, take it over. The FDIC appears without warning at the door of an insolvent bank on a Friday night after the bank has closed for the day and literally takes it over, reopening on Monday under government management. The objective is to minimize depositor panic and maintain normal basic banking operations, an essential public utility. Could this model work for insolvent sovereigns? The equivalent would be a takeover of the government by the international community, which seems totally unacceptable. Presumably, no sovereign government would tolerate being taken over by IMF, even if it were managed in a way that met all the complaints ever made about IMF. Still, it is an intriguing alternative model (Private communications with Patrick Bolton, Columbia University, March 2011).

²¹ Another factor may be the confidence of emerging economy authorities (and their private creditors) that substantial bailout funding would be available on acceptable conditions (appreciation to José Antonio Ocampo for suggesting this point). Indeed, private creditors were highly disturbed at the end of the 1990s when IMF began to make “bail ins” (also called “private sector participation”) as opposed to bailouts part of its international policy statements (see Herman, 2010, pp. 391-395). Both the return to

result, sovereign debt workouts are usually biased towards the interests of the creditors. Either debtors accept that or in infrequent cases have countervailing power to obtain a more favorable outcome or the debt is left unresolved. The Soviet Union repudiated the Czar's bonds in 1918 and payment did not resume on them until the late 1980s. Life went on; but life could have been better.

History tells us that creating a new international mechanism will not be easy. Thus, we must first ask if there is an alternative. If debt crises can be prevented, there is no need to fight for a workout mechanism. Is it possible through cautious fiscal management to prevent the buildup of sovereign debt levels that somehow become excessive? One approach would be to abjure any borrowing or more than in very modest amounts. However, the opportunity cost of that is so high in terms of investment foregone and low standards of living in the borrowing countries that it is not a strategy that societies are willing to adopt. Debt has a place in good fiscal management. The challenge is to use it safely because it has dangers.

So, then, the question may be posed, can borrowing instruments be made less dangerous? In this spirit, there are several proposals to introduce financial instruments that share repayment risks between borrower and lender other than through default, such as bonds or official loans whose repayment obligations would be linked to growth of gross domestic product or export commodity prices. Another proposal is to revive the "bisque" clause used in Anglo-American loan agreements of the 1940s and 1950s under which the borrower (United Kingdom) could at its own option (as from 1956) decide to delay a payment under difficult economic circumstances (Cosío-Pascal, 2010, pp. 235 and 259). With such financial instruments, debt-servicing obligations fall when ability to pay falls and rise when it rises. There has been considerable discussion of these concepts at a philosophical (e.g., Reddy, 2007) and practical level (e.g., Griffith-Jones and Sharma 2006; Claessens 2010, especially pp. 84-87), but very few actual financial instruments have been created in the public or private lending sectors other than as part of a debt crisis workout or as part of development cooperation.²² However, there is a growing interest in the international community in this subject, with the IMF and World Bank, as well as the Commonwealth Secretariat, studying the subject of counter-cyclical lending. It must be that buyers of sovereign bonds or issuers of official credits – at least those on commercial terms – are unwilling to share risk beyond that of default ("credit risk") with the borrowing governments when lending to them.²³

large-scale funding during the recent global financial crisis and the approach taken in the European debt difficulties seem to signal a return to creditor bailouts over "bail ins."

²² In particular, Agence Française de Développement (AFD) has introduced a program of highly concessional counter cyclical loans ("prêt très concessionnel contracyclique"). These loans shorten a previous standard 10-year grace period to 5 years but give countries the option of not paying principal in any ensuing year, up to 5 years total, over the remaining life of the loan, depending on shocks to their repayment capacity, for example, owing to trade-price changes (called a "flexible grace period"); if the borrower does not use all five years of additional grace, the remainder is credited against its final payments so as not to over-repay the loan (for background, see Djoufelkit-Cottenet and Valadier, 2008, pp. 19-22). From initiation in 2007 to 2010 such loans have been extended to five low-income countries (Senegal, Burkina Faso, Mali, Tanzania and Mozambique), according to AFD (appreciation to Stephany Griffith-Jones for bringing this to my attention).

²³ On the other hand, the global financial sector has created securities that act like insurance policies and absorb risks, such as catastrophe and weather-related bonds, which have found voluntary markets, albeit limited ones (see Claessens, 2010, p. 83 and references cited therein). They are not necessarily cheap ways to hedge risk. The international community has also adopted a policy option for very poor countries

One may expect sovereign debt crises will never disappear, however much we may hope that they are infrequent. If insolvency cannot be ruled out, can the need for an explicit workout mechanism still be obviated? One possibility would be if international policy were so structured that no sovereign defaults were permitted, assuring that creditors are always paid fully and on a timely basis. Logically, there are two possibilities: bailouts and a full debtor country squeeze. Bailouts of insolvent government by other governments, as have been used thus far in Europe, have not been popular, even with an accompanying tight squeeze on debtor country citizens, as taxpayers of one country do not want to bear the burden of the taxpayers of another country. To make matters worse politically, the creditors (at least private creditors) have all along been compensated through interest rate premiums for taking the risk that their loans will not be repaid, and so it seems only fair for them to share the pain when the borrower actually cannot pay.²⁴ Equally, it is not always a credible option to hold governments responsible to repay all the debts they accumulate regardless of the pain it inflicts. This is for the same reason that debtors' prisons are no longer in vogue: it is unconscionable to most people for creditors, whether the local or international wealthy, to squeeze living standards of lower income people beyond some limit.

Thus, when an excessive debt situation reaches a point of insolvency, the workout should entail a shared sacrifice of debtors and creditors. Full compensation of all creditors all the time is simply not tenable. It is just not fair (Herman, 2007). Determining the shares of the burden asked of the sovereign debtor and its creditors – and how the different creditors should share their part of the burden – are essential features of the debt workout. That job today is done in the informal and ad hoc ways discussed above, rewarding the politically powerful or politically necessary (Iraq), but not necessarily the needy. This situation begs for improvement.

If the argument is thus strong for trying to create an explicit sovereign debt workout mechanism, is this a propitious time to launch a fight with private and official creditors to create it? Rahm Emanuel, the new mayor of Chicago and US President Barack Obama's former chief of staff famously said in November 2008 "You never want a serious crisis to go to waste".²⁵ But subsequent experience suggests that effective reform does not necessarily get done this way. It seems the lesson of the financial regulation reform effort – at least in the United States where the financial sector continues to fight to weaken it – is that unless you complete the reform while fear is high, the financial sector will succeed in protecting its private interests and roll back the reforms, even if it risks the sector's own broad interests.²⁶ Also, the primary concern of the United States and Europe during the crisis of 2007-9 was to rescue the creditors, not curb their self-destructive behaviors. By the same token, the most

experiencing devastating natural catastrophes, such as Haiti's 2010 earthquake, namely, donor government voluntary suspension of bilateral debt servicing obligations and special arrangements to cover multilateral debt servicing payments falling due, such as the Post-Catastrophe Debt Relief Trust established by the International Monetary Fund in 2010 (IMF 2010a).

²⁴ Indeed, evidence is that investors in emerging market country bonds have been generously compensated for bearing risks that have rarely caused them to suffer any losses (see Spiegel, 2010).

²⁵ As cited by the *Wall Street Journal*, November 21, 2008

²⁶ It seems that financial market participants have dual personalities. While one personality can step back and see the systemic risks and regulatory failings, the other personality only sees the proposed regulatory corrections as limits on its particular operations and earnings, with the latter personality apparently the dominant one today (see Rude (1999) for an examination of the dual personalities on Wall Street during the Asian financial crisis).

propitious time to advance consideration of a debt workout mechanism seems not to be in the midst of widespread sovereign debt crises.

In fact, the short-term outlook may be one of relative financial calm as regards the sovereign debts of developing countries, as noted earlier. The principal danger is if the “romance” with austerity in some of the major developed economies reduces growth of world demand and trade and possibly tips the world back into recession; then the debt outlook in developing countries would sour. On the other hand, the medium-term prospects are quite cloudy, especially as capital flows remain potentially volatile. In addition, the outlook for official development assistance becomes important for those countries that are primarily dependent on official flows to roll over and expand borrowings, as aid commitments of some countries have become more uncertain in recent time due to fiscal pressures from the global crisis.

Finally, even if the current moment of relative calm is propitious for launching a debt initiative, it will surely be a fight. Private and official beneficiaries of the status quo will defend their interests. Nevertheless, financial interests in some developed countries continually amaze with their arrogance and greed and it seems that taxpayers are less willing to defer to their interests than before. If political mobilization to fight those interests gathers momentum, special interests could be overcome. Perhaps the sovereign borrowers who helped kill the SDRM in 2003 would also not protest so loudly now, especially if the end result was a system that reduced uncertainty and made clear how debts would be handled. Indeed, it is very possible that, just as introducing collective action clauses into New York law bonds did not raise interest costs to sovereign borrowers, establishing a sovereign debt workout mechanism might impose no additional cost on sovereign borrowing.

Conclusion: Next Steps?

The argument of this paper has been that the international financial system is missing an important mechanism through which to resolve – hopefully only occasional but typically very costly – sovereign insolvencies. Although in the past international policy makers have thought about one set of policy responses to sovereign debt crises in “market-access” countries (SDRM, collective action clauses for New York law bonds, codes of conduct, Evian Approach of Paris Club) and a different set of responses for low-income countries that mainly borrow from official creditors (HIPC Initiative, MDRI, Evian Approach), this paper calls for creation of a single mechanism that could be used by countries at any level of development, including possibly members of the European Union.

The argument was not made that a new mechanism is *required* to restructure debts of one group of countries or another. The informal and ad hoc processes that have been available will continue to be available, and will surely adjust in one way or another to reflect the changing creditor landscape. In this regard, the existing system is already a very flexible one, calling on different creditor classes to organize themselves however they see fit for negotiation with a given debtor government in crisis. Rather, the call here for a new mechanism is made to achieve *superior* workouts from the perspective of development effectiveness, overall fairness and to send signals to the creditors and debtors that should discourage inappropriate borrowing and lending behavior.

The paper also eschewed specifying what form the new mechanism should take, e.g., whether it should be an international court of some sort or an international arbitration service. It seemed more useful to spell out how the mechanism should function, highlighting the processes that could raise confidence that the outcomes would meet effectiveness, timeliness and fairness imperatives.

Indeed, the paper also calls for international debate about what such a mechanism should look like. As mentioned at the outset, almost a decade ago the international community called for deliberations in the appropriate forums on precisely a proposal such as considered in this paper. It could be added that the call has been reiterated in subsequent United Nations conferences and meetings of the General Assembly,²⁷ and merely awaits an agreement among the major and emerging powers to restart the discussion, which would perforce either be in or centrally involve the Bretton Woods institutions.

Thus far, the financial industries and government authorities of several important countries have simply not been interested. Apparently, the current system works well enough for them or they fear that reform might not serve their interests. To actually restart the substantive policy debate in a global forum instead of repeatedly – and now almost routinely – calling for its consideration requires a consensus of Member States and thus disinterested governments can block the process.

However, the intellectual, technical and political discussion to start developing the proposal does not need to begin in a global forum, although it does need to reflect a balance of interests. If a balanced group of interested governments could agree to start the discussions among themselves, inviting essential institutional and non-state stakeholders to help them, they could develop a credible proposal. Reform is always risky, and thus political leadership to take up an initiative is necessary to start the reform process.

When the group of governments agrees to a proposal, it could very well bring it to an appropriate global forum for further negotiation on its details, global endorsement and implementation. That forum could be a global conference, perhaps held under United Nations auspices but with the active support of the Bretton Woods institutions at the conference and in its preparatory process.²⁸ The preparatory process would need to have participation of finance and foreign ministries, and specialists in finance and international law.

If certain major governments still block moving at this stage to a global discussion, interested governments could come together on an ad hoc basis and create the insolvency mechanism as an ad hoc facility offered for use by any government in need. It is possible that a very large number of countries would participate, as is the case, for example, in the UN Law of the Sea, the UN Convention on the Prohibition of Land Mines, or the International Criminal Court. It is also possible that a group of countries that starts small gathers adherents as its deliberations proceed and international interest grows in its work. Indeed, the “Leading Group on Innovative

²⁷ This includes the outcome of the September 2010 UN Summit on the Millennium Development Goals (United Nations 2010, paragraph 78(r)) and the December 2010 General Assembly debt resolution (United Nations 2010a, paragraph 26).

²⁸ This was the model for the preparation of the 2002 Monterrey Conference on Financing for Development.

Financing for Development” was begun in 2004 by the Presidents of France, Brazil and Chile, joined later by Spain; it held a first conference of interested governments in 2006 attended by 44 countries, of which 17 signaled their intention to introduce the air-ticket solidarity levy, which has in fact been introduced by several governments; today it comprises 63 member countries, international institutions, important foundations and civil society organizations.²⁹

The remaining question is which country or countries are willing to take the first step forward.

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²⁹ Information from www.leadinggroup.org.

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