

PART V
LESSONS



13 SOVEREIGN DEBT MANAGEMENT: LESSONS AND POLICY IMPLICATIONS

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The stability of the international financial system depends on preventing and resolving debt crises. In this concluding chapter we attempt to draw some lessons from the varied opinions expressed in this volume. Consensus seems to emerge on four themes: big bailouts should end; the role of the IMF should be limited; disorderly workouts are costly; and although good economic policies should be rewarded, political discretion means that bailouts are generally driven by creditor governments. These views suggest that a major focus of debt restructuring should be on the reform of *ex ante* contracts and on enhancing cooperation between private and public creditors. These changes, rather than the creation of new institutions or a significant modification of the IMF's role, appear to be much more politically and economically practicable.

13.1 BIG BAILOUTS SHOULD END

Moral hazard, or the tendency for economic agents to be less careful when they do not expect to bear the full consequences of their behaviour, was seen to have played a substantial role in the financial turmoil of the 1990s. A key issue, then, is, how can one devise a successful debt-rescue package without encouraging investors to engage in unduly risky ventures and debtors to pursue irresponsible economic policies? The growing size and increasing frequency of rescue packages orchestrated by the International Monetary Fund in the 1990s, and the problems of debtors in managing their debts, points to the conclusion that incentives for both lenders and borrowers need to be altered fundamentally.

Estimating moral hazard is a complex task, because of the difficulty of adequately assessing the costs that would have been borne by the international financial system if a rescue effort had not been mounted (Giannini 1999: 26). For instance, after 1982, 35 countries followed Mexico into default. Many argue that the IMF most probably helped to prevent a world depression of the type

The first section of this chapter draws on Granville (2002).

experienced from 1929. On the other hand, one might argue that the IMF packages in the 1980s themselves encouraged reckless borrowing and lending in the 1990s (James 1999: 8). During the Mexican of 1994–5 crisis, a rescue package coordinated by the IMF and creditor governments was put in place as follows: a \$17.8 billion IMF stand-by agreement, amounting to 688% of Mexico's quota; an additional \$20 billion from the US and \$10 billion from the G-10.¹ The scheme appears to have successfully stopped the 'Tequila effect' – the contagion that many feared would affect not only other Latin American economies with large current account deficits but also Asia and, ultimately, mature markets such as the United States.

However, as the Asian crisis developed in 1997 and spread to Russia, a diverse set of critics suggested that emerging markets were made even more attractive: the 1994–5 Mexican crisis was perceived to show that guarantees were in place against debt default. In other words, banks and other investors began to believe that sovereign debtors with large amounts of debt were 'too big to fail'. This view appears to be supported by the evidence that money continued to flow into Asian countries in 1997 – even though widely available statistics made it clear that the level of short-term international bank lending had risen precipitately.

The 'too big to fail' argument was sharply challenged by the case of Russia. It defaulted a mere four weeks after it had secured an IMF-led rescue package worth \$22.6 billion. Russia defaulted and devalued – it was allowed to fail – even though the IMF's 'bailout' programme remained on track (Granville 2001). This event introduced uncertainty into financial markets and led lenders to demand higher returns and to reassess their risk strategy.

13.2 A NEW ROLE FOR THE IMF?

The IMF's original mandate was to deal with current account imbalances, and capital account problems were to be dealt with through the imposition of capital controls. With the collapse of the par-value system in the early 1970s, the liberalization of capital flows and the growing private-sector capital market, the IMF's role became to manage liquidity crises originating in the capital account and to supervise capital markets. But many (see Deepak Lal, Chapter 4, in this volume) identify the IMF as the main culprit in generating the moral hazard problems discussed above.

Although some believe that the IMF should be abolished, others argue that it is a valuable international institution – but one that needs to be reformed. For example, Marcus Miller and Lei Zhang argue in Chapter 9 of this book that

¹ The Group of Ten is made up of 11 industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States); its members consult and cooperate on economic, monetary and financial matters.

instead of being a direct provider of emergency lending, the IMF should become more like a bankruptcy court and protect debtors from premature liquidation. In their view, this would help to avoid both routine rescues and devastating defaults. Given the lack of international enforcement mechanisms comparable to domestic systems, this supranational bankruptcy court could encounter the risks described by (Rogoff 1999: 30): ‘... lack of enforcement clout in debtor countries is the main problem with an international bankruptcy court. If the court has no teeth, and lenders can no longer fall back on national courts (whose jurisdiction would be superseded by the international court), there could be a sharp fall in international bank lending.’

To address this lack of international enforcement, Krueger (2001) advocates ‘an international workout mechanism’ rather than an international bankruptcy court scheme. The ‘Krueger mechanism’, or the so-called sovereign debt restructuring mechanism, is the natural extension of the framework adopted by the IMF executive board on private-sector involvement in forestalling and resolving financial crises (see Miller and Zhang, Chapter 9, in this study). Private investors could be asked to share some of the responsibility for the continuing provision of credit to customers to whom they had previously lent. In addition, contingent liquidity facilities could be developed in which the private sector would take an important stake, and improved arrangements could be developed for coping with moratoria on foreign debt. To shelter countries initiating debt negotiations from legal action, Article 8.2(b) of the IMF’s Articles of Agreement would be amended to allow the IMF to impose a standstill.

The private sector opposed the notion of IMF-sanctioned standstills, arguing that this approach unduly favoured debtors. The IMF was also accused of encouraging countries to default on debt and encouraging aggressive holders of defaulted bonds to take unilateral action to freeze assets of the sovereign debtor in foreign jurisdictions by using the threat of litigation as a bargaining lever. Despite fears and threats, litigation did not occur during debt restructuring by the Ukraine, Pakistan and Ecuador. This absence of legal action was relatively surprising because in the case of Pakistan, the Paris Club required the Pakistani authorities to approach their bondholders and seek ‘comparable treatment’ to the relief it offered. The fear of litigation was borne out, however, in the case of Elliott Associates and Peru in which Elliot Associates bought Peruvian commercial loans and then obtained a judgement against the Peruvian government for full payment.²

² As Krueger (2001: 4) notes, ‘In 1997 Elliott Associates bought \$20m of commercial loans guaranteed by Peru. Rather than accepting the Brady bonds offered when Peru tried to restructure its debt, Elliott demanded full repayment and interest. In June 2000, it obtained a judgement for \$56m and an attachment order against Peruvian assets used for commercial activity in the US. Elliott targeted the interest payments that Peru was due to pay to its Brady bondholders who had agreed to do the restructuring. Rather than be pushed into default on its Brady bonds, Peru settled.’

The private sector argues that it has always made a substantial contribution when a country defaults or shows signs of financial difficulty. As evidence, it points to the rollover of loans for South Korea in 1997–8, to credit backstop facilities for Mexico in 1995 and Argentina in 1997) and to bond exchanges with new money components for Brazil in 1997. But as Aggarwal points out in Chapter 2 of this book, these actions, especially in the case of South Korea, were driven by severe pressure from creditor governments rather than by voluntary action. The private sector also argues that burden-sharing is not symmetrical. Although private-sector investors are now drawn into debt restructuring involving IMF lending, the reverse is not always true. Official creditors such as national governments that comprise the Paris Club have escaped the effects of some private-sector debt restructuring, as in the case of Russia.

Although the private sector and the US Treasury are against increasing the role of the IMF, as Miller and Zhang point out in this book, the current approach to debt rescheduling and the high costs involved point to a need to improve the debt-restructuring process.

13.3 DISORDERLY WORKOUTS ARE COSTLY

Estimating moral hazard is a complex task because of the difficulty of adequately assessing the costs that would have been borne by both the international financial community and the debtor country if a rescue effort had not been mounted.³ In cases where crises have been caused by contagion rather than by poor economic fundamentals, the case for bailouts may be even stronger (Fratzcher 1995). Moreover, once default on sovereign debt occurs, rescheduling is often highly complex and lengthy (Aggarwal 1996).

One approach to managing the problems of international debt is to focus on improving the process of debt-rescheduling negotiations through changes in the types of contract developed by the private sector with borrowers. As currently designed, sovereign debt contracts are structured in the form of American-style bonds. Under these terms, modifying bond contracts requires unanimous agreement among bondholders. This constraint makes restructuring extremely difficult because any dissident can sue the issuer of the bonds. Unlike syndicated loans, American-style bonds do not include a sharing clause requiring individual creditors to split any amounts they recover with other bondholders. In practice, this means that nothing can be done to stop an investor from proceeding with legal action. By contrast, contracts under English law typically provide for qualified majority voting and are more likely to facilitate debt restructuring.

³ Giannini (1999), p.26.

In 1995 Barry Eichengreen and Richard Portes (1995) suggested that contractual provisions governing sovereign debt be changed to include so-called collective action clauses (CACs). Contracts would be written to incorporate measures such as qualified majority voting in order to modify the terms of a bond contract, including the rescheduling of principal and interest, and collective representation of bondholders. They would mandate a sharing clause for funds received by any creditor from a debtor.

Initially, CACs were opposed by the private sector, which argued that these contractual revisions would raise funding costs for emerging-market borrowers and damage investor confidence and systemic liquidity. This line of argument was rather puzzling. Indeed, if a better chance of debt restructuring in a future crisis can be achieved and can raise spreads and limit access to global finance by uncreditworthy borrowers, these modifications in the terms of bonds should be seen as a positive step forward. Instead, the private sector favoured market-based options, that is market-based exchanges across all debt categories, as opposed to this regulatory change. It also favoured a level playing field for all creditors, regardless of financial type or size; encouraging competition among workout approaches; and building in incentives for new dollar options as well as for promoting present-value approaches and recognizing different investors' utilities. The problem with these options is the question of who will provide new credit for sovereigns showing signs of difficulty.

Since Anne Krueger's speech at the National Economists' Club in November 2001 proposing a Sovereign Debt Restructuring Mechanism (SDRM), the private sector has radically changed its position. In a memorandum to the G-8 on 11 June 2002, the leaders of five private-sector groups of financial institutions released six principles on debt crisis management.⁴ The principles include the use of CACS in sovereign debt contracts. The memorandum reflects an industry consensus to support the US Treasury position of April 2002 for a market-oriented approach towards sovereign-debt restructuring based on contractual arrangements. This approach was also supported by the United States' fellow members of the G-7. Canada and the United Kingdom were the first to introduce these clauses in 2000. It seems that with the new support of the US Treasury and the private sector, bond contracts are likely to be modified.⁵

⁴ See 'Financial Industry Leaders Announce Consensus on Crisis Management and Sovereign Debt Restructuring, Market-Based Principles Agreed by Major Global Associations', Press Release, 11 June 2002. These institutions are: the Emerging Markets Creditors Association (EMTA), the Institute of International Finance (IIF), the International Primary Market Association (IPMA), the Securities Industry Association (SIA), the Bond Market Association (BMA).

⁵ See Miller and Zhang in this volume for the various options opened in the transition period.

13.4 THE ROLE OF CREDITOR GOVERNMENTS AND THE ISSUE OF CONDITIONALITY

External loans should be used to finance sustainable growth, which in turn should allow countries to reimburse their debts and to be less dependent on capital flows. In short, debt relief should be the reward for good economic policy. Good economic policies, however, should be strictly defined and prioritised, to avoid overburdening debtor countries with excessive conditionality.

Too often, however, loans are misused, as noted by William Easterly (2001), and poorly performing countries are repeatedly rewarded with London Club and Paris Club debt restructuring and with structural adjustment programmes by the international financial institutions. Also, debt relief is often granted to debtors owing to the political motives of creditor countries, as in the case of the United States' concern for Pakistan after the 11 September attacks. In Chapter 10 of this book, Thomas Callaghy quotes a Western creditor official to the effect that '... the IMF can rarely provide a really good analytic answer to what [debt] sustainability is "until it knows what the political context is"'. In short, political discretion seems to be the norm, rather than good economic policies (see Chapter 2 by Aggarwal in this volume). The risk, therefore, is that private creditors could be asked to share the burden by politically motivated Paris Club governments.

To address the issue of politicization, some, such as Gray in Chapter 8 in this volume, advocate that banks should adopt a generally accepted 'code' of good market behaviour and call for debt negotiations to be more transparent and less protracted. This would mean that debtor countries should be given a more powerful voice in institutions that govern international finance (see Griffith Jones, Chapter 7, in this volume). In addition, NGO networks could have an active role. Having already managed to catalyse the transformation of the existing multilateral debt regime, they could play an important part in the creation and operation of new forms of governance (see Chapter 11 by Fogarty in this volume). They could also help in making sure that poor countries have market access to their products, according to Granville (see Chapter 3 in this book).

In conclusion, many of the more interventionist approaches to these problems imply an often unacknowledged ideal of world governance. Establishing the IMF as a formal debt-resolution coordinator will produce tensions with sovereign governments and jurisdictions in which private contracts are framed. It may be that excessive formalization and the creation a formal 'architecture' in the field of sovereign-debt resolution is a dead end.

The lack of a formal process of debt resolution may be only a realistic recognition of geopolitical realities and the interests of creditor countries. A lack of formalization may also serve to increase uncertainty, which could be as effective in disciplining private investors as the schemes for formal burden-sharing surveyed above. Indeed, if debt restructuring were made easier for debtors,

surely moral hazard would increase (Cline 2000). From the lender's point of view too, the lack of certainty of a guaranteed bailout is the best way to reduce the need for bailouts in the first place. This very uncertainty can provide the necessary discipline to dissuade lenders from engaging in excessively risky lending.

What is clear, however, is the universal recognition that something needs to be done to prevent drama such as was observed in Argentina. One can only hope that eventually a dialogue will take place between the private and official sector leading to a consensus on the management of international debt resulting in lower financial and human costs.

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