

Restructuring Sovereign Debt

Barry Eichengreen

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley, California; Research Associate, National Bureau of Economic Research, Cambridge, Massachusetts, and Research Fellow, Centre for Economic Policy Research, London, United Kingdom.

At the end of 2001, in a speech to the National Economists' Club, Anne Krueger, the First Deputy Managing Director of the International Monetary Fund, pointed to a flaw in the international financial architecture. "We lack incentives," Krueger (2001, p.1) observed, "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."

This observation, coming from the number two official of the institution at the center of crisis-management efforts, immediately became a flash point of the so-called "architecture debate." It spoke to the widespread belief that the market for emerging-market debt is in jeopardy. Private capital flows to emerging markets fell to barely \$112 billion in 2002, down from an average of around \$185 billion over the preceding ten years, and they are forecast to recover only slightly in 2003, as shown in Table 1. Medium- to long-term net nonbank lending to emerging markets (primarily bond flows) declined even more precipitously from a peak of \$88 billion in 1997 to \$12 billion in 2002. While a variety of factors may have contributed to this stagnation, there is a broadly shared sense that the frequency of sovereign debt crises -- starting with Mexico in 1994, extending through Russia in 1998 and culminating in Argentina in 2001 -- and the manner in which these crises were dealt with by the private and public sectors have had much to do with the demoralization of the market.

But if there is broad agreement on the kind of steps that are needed to limit the frequency of financial crises -- the consensus list emphasizes strengthening macroeconomic policies, improving the supervision and regulation of financial systems, and developing techniques for more promptly identifying looming risks (IMF, 2002a) -- no similar consensus exists about how

to manage and resolve sovereign debt crises once they occur. Some suggest that institutional reforms making it easier for the private sector to restructure unsustainable sovereign debts would provide a more attractive alternative to IMF financial assistance, and that getting the IMF out of the bailout business would reduce excessive-risk taking and help to stabilize the international financial system (Group of Twenty Two, 1998). Others argue with equal conviction that such reforms would be superfluous (Roubini, 2001) or even counterproductive (Porzecanski, 2003). Some join Anne Krueger in arguing that significantly enhancing the efficiency of sovereign debt restructuring would require creating a statutory process – not exactly an international bankruptcy court, but a set of mechanisms and procedures inspired by it. Such a step would require amending the IMF’s Articles of Agreement to override any conflicting provisions of national law, rendering the resulting treaty-based obligations binding on all countries. Others prefer a more decentralized process that would specify the procedures for restructuring a sovereign debt instrument at the time it is issued (Hubbard, 2002).

Not surprisingly, these conflicting positions are informed by very different views of the nature and pervasiveness of the distortion giving rise to financial crises in the first place.

Motivations

Rogoff and Zettelmeyer (2002) distinguish two rationales for efforts to make sovereign debt restructurings more efficient, orderly, and predictable: deadweight losses and moral hazard.

Deadweight Losses

A first motivation is that inefficiencies associated with current arrangements impose

deadweight losses on lenders and borrowers. Information problems – for example, uncertainty about the debtor’s willingness and ability to pay – encourage lenders and borrowers to engage in costly wars of attrition, unnecessarily delaying agreement on restructuring terms. Even when disagreements between borrowers and lenders are put to rest, coordination problems among the creditors may hold up acceptance of a restructuring offer. For example, a dissenting creditor may block agreement in an attempt to be bought out on more favorable terms.

In the interim, lenders receive no interest and the borrowing country has no access to international capital markets. An extended loss of access to foreign finance may cause the exchange rate of the borrowing country to collapse and banks of that country with foreign-currency-denominated liabilities to fall prey to a crisis. This extended loss of market access, financial stress, and the recession that it provokes may have very high costs for a country -- even higher costs than a situation of financial distress for a corporation (Bolton, 2002, p. 28). Officials in the borrowing country consequently may feel compelled to pursue costly adjustments to avoid this plight. To avoid having to suspend debt service payments, they may run down their reserves, raise their interest rates, and put their economy through a deflationary wringer, all at considerable cost to society.

These costs could be reduced, the implication follows, if countries with unsustainable debts reorganized sooner and if debtors and creditors were able to agree more rapidly on restructuring terms. A more efficient mechanism for debt workouts that dealt better with information and coordination problems is needed to make this possible.

Not everyone agrees, however, that debt restructuring is so difficult or that the costs are prohibitive. Ecuador, Pakistan, Russia and Ukraine were all able to restructure their bonded debts in recent years, securing substantial debt-service relief and even significant write-downs of

principal. They made imaginative use of techniques such as exchange offers (in which they offered to exchange existing bonds for new instruments that offer cash flow relief – a reduction in short-run interest and amortization payments – but not a reduction in the present value of the bondholders’ claims). These succeeded in achieving very high acceptance rates among creditors: 99 percent in the case of Pakistan, 97 percent in Ecuador, 99 percent in Ukraine and 96 to 99 percent in Russia (where the exchange came in two stages). The remaining bondholders continue to hold the original instruments in the hope of eventually obtaining better terms. As Sturzenegger (2002) notes, bondholders have several reasons to participate: the new issues will be more liquid than the old instruments, and creditors may fear default if the exchange is unsuccessful. In several cases, these countries were able to reenter the international capital market with surprising speed.¹

Nor does everyone agree that the costs of debt restructuring, such as they are, represent a deadweight loss. Authors like Dooley (2000) argue that the prospect of output losses from default are necessary for governments to have an incentive to repay, given the immunity of sovereign debtors from legal action. A more predictable process that involves less output foregone might therefore tempt the governments of emerging market economies to declare themselves incapable of repaying, leaving investors reluctant to lend. In this view, the distinctive weaknesses of the sovereign debt market – its low levels of liquidity, high volatility, and substantial spreads – reflect not that the restructuring of unsustainable debts is too difficult but that it is too easy. The reality is not that sovereign debt suddenly becomes “unsustainable,” raising the question of what to do about it. Unsustainable debt can be a consequence of endogenous policy choices by the borrowing government, which might only be encouraged by a mechanism for more smoothly resolving defaults. This perspective makes the problem not one

of dealing with unsustainable debt but one of organizing the market so that defaults are less frequent and the interest rates that countries pay are lower (Shleifer, 2003).

This argument has limits. Sometimes debts are rendered unsustainable for reasons beyond the control of the borrower. If dire consequences that flow from the debtor's inability to service its debts, then that debtor may become reluctant to borrow in the first place, and attractive investment project may go unfunded. Although Chapter 11 of the U.S. bankruptcy code has been criticized as too debtor-friendly, no one goes so far as to recommend the reinstitution of debtor's prison or other severe to punishments for debtors – although this would presumably reduce the cost of borrowing in those few remaining cases where borrowing still took place. The problem is to strike the right balance between making restructuring not too hard and not too easy.

Moral Hazard for Investors

The international policy community often views the costs of default as unacceptable, as evidenced by the frequency with which it feels compelled to intervene, evidently with the goal of limiting the magnitude and impact of defaults. This brings us to the second rationale for reform, namely, to limit moral hazard. This motivation derives from the observation that the same costs of restructuring that place pressure on the IMF to provide emergency assistance also encourage investors to lend to the prospective recipients of official assistance. An IMF loan that allows a country to pay off its maturing credits may also make it possible for holders of those obligations to exit without losses. But because the IMF typically gets paid back (instances of arrears on IMF loans being the exception to the rule), the residents of the crisis country end up footing the bill. Their taxes give the government the resources with which to repay its IMF loan and ultimately to

guarantee private investors 100 cents on the dollar. Thus, the intervention of the IMF may lead to a situation where some of the burden of sovereign default is transferred from private sector lenders and investors to citizens of the debtor country.²

Reducing the frequency and magnitude of IMF rescue operations requires creating an environment where a commitment by the official community to stand aside is time consistent (Miller and Zhang, 2002). The IMF and the industrial-country governments that are its principal shareholders, like a national central bank that sees a distressed financial institution as too big to fail, are responding to the concern that not intervening would have unacceptable costs. One motivation for new approaches to sovereign debt restructuring is thus to open up less costly avenues for debt reorganization, thereby reducing the pressure on the IMF to lend and removing the incentive for investors to engage in additional lending in anticipation of official intervention. This connection was made explicit by U.S. Undersecretary of Treasury for International Affairs John Taylor in testimony to the U.S. Congress, in which he argued that contractual innovations making sovereign debt restructurings smoother, more orderly and more predictable would make it “easier for us to adhere to access limits we would like to adhere to” (Despeignes and Beattie 2002, p. 3).

There is considerable disagreement over whether the prospect of IMF rescues in fact encourages risk taking by investors. Some authors like Mussa (2002a) argue on a priori grounds that this danger has been overblown. They observe that investors still demand significant spreads over U.S. Treasury bonds when purchasing emerging market debt, indicating that they do not expect that official assistance will automatically guarantee that they are repaid in full. The quantitative literature analyzing the determinants of emerging spreads as a way of attempting to identify the existence and magnitude of moral hazard effects among investors is

similarly inconclusive. While Sarno and Taylor (1999), Chang (2000) and Spadafora (2001) find evidence of investor moral hazard, Zhang (1999) and Kamin (2002) do not.³

Why Now?

Recent years have seen a strong push by the international policy community to alter the mechanisms by which sovereign debts are restructured. Yet sovereign defaults are hardly new. Why then all this sudden attention to the problem?

The current debate can be traced to a lesson drawn from the Mexican crisis of 1994-95 and subsequently reinforced by the Asian, Brazilian and Argentine crises, namely, that recent developments in international financial markets have heightened information and collective action problems. In the 1970s, most sovereign debt was held in the form of medium- to long-term syndicated bank loans. Bank syndicates had limited numbers of participants, facilitating communication, collective action, and the application of moral suasion by governments, while covenants attached to these loans, such as sharing clauses that required an investor initiating legal action to share the proceeds with other creditors, discouraged disruptive litigation (Buchheit 1990).

Then came the sovereign debt crisis of the 1980s, which was resolved at the end of the decade by the Brady Plan, when many bank claims were converted into securitized instruments (Brady bonds), creating a liquid market in the international debt securities of developing countries. Some 60 percent of the outstanding public external debt owed to private creditors now takes the form of bonds. Market participants see this as progress. Because securitized instruments are more liquid and widely held, they have better risk-sharing properties. But

because bondholders are more numerous and heterogenous than the members of the typical bank syndicate, securitization also creates a greater risk that the hold out of a few lenders will make it difficult to resolve a sovereign debt failure. Whereas syndicated bank loans include sharing clauses to discourage opportunistic litigation, the same is not true of sovereign bonds issued in the United States.² In addition, official arm-twisting has been rendered less effective by the growth of the bond market. Whereas back in the 1980s the U.S. government could use regulatory incentives and moral suasion to pressure banks to reach agreement on negotiating sovereign loans, most bondholders are not susceptible to such pressure.

A number of reports done in the aftermath of the sovereign debt crises of the 1990s have emphasized how developments in international financial markets have heightened information and collective action problems with regard to sovereign debt. These patterns were highlighted in a post mortem on the Mexican crisis commissioned by the Bank of England (Eichengreen and Portes, 1995), in a subsequent report of the Group of Ten (1996) countries, and in the report on crisis resolution issued in the wake of the Asian crisis by the Group of Twenty Two (1998). But it took the Argentine crisis of 2001-02 to drive home the point.

That crisis is now the subject of a large literature (Mussa, 2002b). The key stage came in August 2001 when the IMF and its shareholder governments agreed provide Argentina with an additional \$8 billion of assistance. When doing so, the IMF earmarked \$3 billion, to be brought forward from later disbursements, to support a voluntary, market-based operation to improve Argentina's debt profile – in effect, for a restructuring operation designed to reduce the country's immediate debt-servicing obligations. Frustratingly, however, no one could figure out how to make use of that \$3 billion; collective action problems made it difficult to obtain the participation of creditors in a voluntary restructuring. The creditors were reluctant to agree to a

voluntary restructuring precisely because it was voluntary; they preferred to wait and see whether the multilaterals would provide additional assistance (Eichengreen, 2002, p.126). In the end, the official community felt that it had no alternative but to lend, because doing nothing and thereby forcing the country into a messy and difficult restructuring risked endangering Argentina's neighbors and an already fragile international financial system. At the same time, officials feared that this action only put off necessary institutional and political reform. As Fischer (2002, p. 37) put it, "Under present circumstances, when a country's debt burden is unsustainable, the international community – operating through the IMF – faces the choice of lending to it, or forcing it into a potentially extremely costly restructuring, whose outcome is unknown."

Options for Reform

Options for reform include keeping the status quo, promoting the development of more complete and efficient debt contracts, a statutory approach that would provide some but not all of the functions of an international bankruptcy mechanism, and finally the creation of a full-fledged international bankruptcy court. National and international officials evidently regard the status quo as untenable (for example, Taylor, 2002; Krueger, 2001). The representatives of some nongovernmental organizations would plump for a full-fledged sovereign bankruptcy court (for example, Jubilee Plus, 2002), but academics and officials tend to be skeptical of such ambitious schemes, fearing that the creation of a new judicial entity with extensive powers to override national law and private debt contracts would significantly weaken creditor rights, which would make it more difficult for emerging markets to fund their development needs. They fear that a

sovereign bankruptcy court would involve a court pursuing development goals, which is exactly the opposite of what normal bankruptcy courts are supposed to do.

The policy debate therefore centers on the merits of a contractual approach, which would encourage the use of more complete and efficient debt contracts, versus a statutory approach which would create a treaty-based mechanism for restructuring problem debts.

The Contractual Approach

One way of understanding the difficulty of restructuring sovereign debt under present institutional arrangements is that inter-creditor relations are governed by incomplete contracts. Typically, sovereign bond contracts in the United States provide only the sketchiest guidance for what to do in the event of default. They make no provision for a communication center for the bondholders, for restraints on disruptive litigation, or for a majority vote by the bondholders on changes in payment terms. The omission of contractual rules of the road is part of what makes creditor coordination so difficult and sovereign debt restructuring so costly and unpredictable. In this view, the key to more orderly restructuring is to encourage lenders and borrowers to specify more complete contracts that lay out the procedures for restructuring at the time the debt obligation is incurred.

Actually, it is not necessary to consider these questions in the abstract, for virtually all sovereign bonds issued in London and subject to UK law already include the relevant “collective action clauses,” which is the omnibus term given to provisions in bonds that spell out how a default will be addressed. The key collective action clauses involve collective representation, majority enforcement, and majority restructuring.

Collective representation clauses provide for the establishment of a representative forum

– a bondholders meeting – where the creditors may exchange views and information. In addition, bonds governed by English law typically specify procedures for selecting a bondholder’s representative and enumerating that party’s responsibilities. That representative, generally the trustee, is empowered to communicate the bondholders’ negotiating terms to the debtor. Bonds governed by U.S. law instead typically provide for a fiscal agent, who has a variety of administrative responsibilities but lacks the power to speak for the bondholders in negotiations. The fiscal agent is an agent of the issuer rather than of the bondholders, mainly responsible for keeping track of interest and amortization payments and distributing these to the holders of the debt securities.

English bonds generally prohibit individual creditors from initiating litigation but instead include *majority enforcement clauses* in which litigation decision must be made by a requisite fraction of the bondholders (say, 25 per cent). The power to initiate litigation is vested with the trustee, acting on the instruction of creditors holding a specified fraction of the principal, who is required to distribute all funds recovered in proportion to the principal amount. De facto, these provisions have the effect of “sharing clauses” in which no bondholder can benefit disproportionately from filing suit. Most U.S.-law bonds do not provide for a trustee and do not feature comparable limits on litigation or a requirement to share the proceeds with other bondholders.

Majority restructuring clauses specify the share of the bondholders whose vote suffices to amend payment terms like the timing and amount of principal and interest. In English-law bonds, the typical shares are two-thirds of the notes represented at a first meeting of the bondholders and smaller shares at subsequent meetings. Changes endorsed by the specified

majority are then binding on all bondholders. These clauses are routinely included in bonds issued under English, Luxembourg, and Japanese law but not those issued under New York law. As White (2002, pp. 303-4) observes, these bonds “lend themselves to restructuring, because a minority of holdouts can be forced to accept changes in bond terms.”

At the end of 2001 nearly 70 percent of the \$354 billion in international sovereign bonds outstanding was issued under U.S. or German law, essentially none of which include collective action clauses. Virtually all of the rest, however, included these provisions.³ Table 2 shows the countries and thus the legal regimes where sovereign debt had been issued as of the end of 2001.

If more complete contracts have advantages, then why are they not more widely used? The divergence of American and British practice is of relatively recent origin (Buchheit and Gulati, 2002). The need for bondholder cooperation first attracted attention in the nineteenth century, when railroads and industrial corporations began issuing bonds in large numbers. The combination of widely disbursed bond holdings and costs of liquidation made it inefficient to allow a single creditor to force the liquidation of the debtor, since this would either entail deadweight losses or force other parties to buy out the uncooperative creditor to forestall liquidation, often at considerable cost. In England, a market solution was found in the introduction of majority action clauses in bonds starting in the 1870s. These clauses, like those included in English-law bonds today, allowed a super-majority of bondholders to agree to reduce the amount due under a bond, and made their decision (when ratified by a vote of the specified majority) binding on all bondholders, including any who had not endorsed the change.

In the United States, in contrast, majority action clauses were never widely utilized. To prevent inefficient liquidation, investors relied instead on the intervention of the courts. One

reason for the lack of popularity of majority action clauses may have been that the exceptionally convoluted capital structure of U.S. corporations rendered market-based restructuring all but infeasible (Skeel, 2002). Another was that a contract providing for post-issuance changes to payment terms might not qualify as an unconditional promise to pay and consequently its marketability would be impaired. Before the 1920s, most U.S. corporate bonds were therefore reorganized under the court-led procedure known as an “equity receivership,” and in the 1930s the Congress amended the Bankruptcy Act to facilitate supervision of corporate reorganizations by a bankruptcy judge (Swaine, 1927; Buchheit and Gulati, 2002).

In the 1930s, prior to adoption of the Trust Indenture Act (whose provisions are described momentarily), majority action clauses appear to have been included in at most 10 per cent of new issues in the United States. Even when used, however, these provisions were regarded with suspicion. Rather than protecting the majority of the creditors against free riders, they were often seen as allowing a few corporate and Wall Street insiders, who might hold the majority of the bond issue and also equity claims on the firm, to redistribute surplus from bond to equity holders and from small creditors to themselves. William O. Douglas, member and then chairman of the Securities and Exchange Commission, held hearings and published articles that developed this view (for example, Douglas 1940). The result was the Trust Indenture Act of 1939, which included a Section 316(b) that prohibited any reduction in the amount due under a publicly-issued corporate bond without the consent of each and every bondholder. This restriction was feasible – it did not lead to a spate of inefficient liquidations – because of provisions of U.S. bankruptcy law allowed the courts to substitute for the missing provisions.

This history helps to explain why majority action clauses have not been included in

corporate bonds issued in the United States, but it cannot explain why such provisions are excluded from sovereign bonds. The Trust Indenture Act of 1939 does not apply to sovereign issues. The rationale for applying it would be weak, since there exists no court-led alternative for sovereign debt reorganization akin to that available to corporations under U.S. bankruptcy law. This of course is precisely the problem that recent initiatives seek to address.

Recall that virtually no bonds of foreign sovereigns were issued in New York between 1940 and 1990. Initially, the international bond market was depressed by the sovereign defaults of the 1930s. Its recovery was then discouraged by the proliferation of international capital controls and by tight regulation of what foreign assets could be held in individual and institutional portfolios. In the 1970s, the bond market was superceded by syndicated bank lending to developing countries, which came to grief in the debt crisis of the 1980s. When the international market in the bonds of developing countries was finally reinvigorated by the Brady Plan, there were no practicing attorneys in New York with first-hand experience in drafting provisions to regulate the amendment of sovereign debt contracts. The attorneys in question apparently just applied the template used in corporate bond contracts.

That collective action clauses have not come into more widespread use subsequently could suggest that the markets regard them as undesirable. Allowing a majority vote to cram down restructuring terms on dissenting investors might tempt the debtor to buy back a sufficient share of the issue to engineer the necessary majority, or the government might be able exert moral suasion over domestic institutional investors who had purchased the bonds on the secondary market. A possible solution to this would be to raise the level of the requisite qualified majority: the Emerging Market Creditors Association has suggested thresholds such as

90 and 95 percent. Similarly, making it easier for the creditors to agree to a restructuring might make it more tempting for the debtor to restructure, since the length of period during which relations with the creditors were in disarray would be correspondingly reduced. If the result was a weakening of creditor rights, investors might have good reason to shun contracts with these provisions.

Of course, it is not obvious that making it easier for the creditors to coordinate in forming of a common front would weaken their position. Nor is it obvious that debtors would take advantage of the presence of collective action clauses by acting opportunistically. Indeed, in cases where restructuring was unavoidable, for reasons beyond the control of the debtor, mechanisms that allowed the situation to be normalized more smoothly by facilitating coordination among the creditors would presumably help to avoid an extended period when no interest was paid and no principal was recovered. In other words, the creditors would find their position strengthened, not undercut.

But if collective action clauses would make debt restructuring more efficient, why have they not been more widely adopted? Authors like Allen and Gale (1994) suggest five reasons that socially desirable financial innovations may fail to emerge. Because of *product uncertainty*, investors may be uncertain about the performance characteristics of the new financial instrument – for example, the commentary of market participants suggests considerable uncertainty about whether greater ease of restructuring will make restructuring more frequent. There may be a *first-mover disadvantage*, if the costs of designing the new clauses and educating investors about them are incurred by the originator and then other entrants can free ride on these investments and quickly compete away any higher returns. There may be *coordination problems* if a number of

borrowers must issue these instruments simultaneously to create deep and liquid secondary markets. New financial instrument may have *positive externalities for the stability of the international system*, but individual borrowers have only weak incentives to internalize this externality by adopting such new provisions. Finally, *political distortions* can arise when politicians facing reelection have shorter time horizons than society as a whole and thus prefer inflexible provisions that reduce costs of borrowing now, even if these provisions create costs of restructuring that are inefficiently high from a social point of view. Alternatively, creditors may prefer a regime where they are bailed out to one in which debt is restructured, and they may be able to resist the adoption of rules and regulations that favor restructuring and limit the pressure for official assistance.

It is unclear to what extent to which these limitations on financial innovation have slowed the addition of collective action clauses to sovereign debt instruments. Product uncertainty is widely cited as an obstacle to their more widespread use, but the fact that a sizeable minority of sovereign debt has traditionally already been issued with such clauses, which suggests that the level of product uncertainty and first mover disadvantages should be lower than for a completely new financial innovation. Coordination problems and the need to create a more liquid secondary market can be addressed by encouraging a few advanced-industrial countries and high-income emerging markets to move simultaneously. Thus, the governments of Canada and United Kingdom have agreed to include collective action clauses in their loan contracts, and the Switzerland and the European Union (which includes countries like Spain and Sweden which regularly issue sovereign debt in foreign jurisdictions) have committed to doing the same. In February 2003, Mexico issued \$1 billion of global Eurobonds including collective action clauses,

in an action that was seen as a response to pressure for an investment-grade country to set a precedent in the interest of the greater good.⁵ The first-mover disadvantage may similarly be surmountable by coordination. For example, the inadequacy of incentives for individual financial firms to develop innovative clauses can be addressed by encouraging members of the industry to cooperate on the design of new contractual provisions. Six private sector financial groupings, led by the Emerging Market Creditors Association (2002), have already cooperated on the development of model covenants for new sovereign bond issues. A working group of the Group of Ten countries (Group of Ten 2002) has also issued a report on the design of contractual clauses.

Thus, there is clearly some momentum toward greater use of collective action clauses. As borrowers and investors gain greater experience with price and performance characteristics of these instruments, any remaining problems involving product uncertainty or a lack of deep and liquid secondary market should become less serious. It may just take time for these provisions to work their way into the market. After all, the market in sovereign bonds has only been active again for a little more than a decade. All we may be observing, in other words, is the gradual response of the financial industry to the efficiency implications of securitization.

If, on the other hand, the failure to make more widespread use of collective action clauses reflects externalities (that they have implications for the stability of the international financial system that are incompletely internalized by the issuing government) and political distortions (that impatient politicians are unwilling to pay costs now for greater financial stability in the future), then there may be a case for subsidizing or mandating their use. Although the U.S. and European governments have embraced the argument for including collective action clauses in

international bonds, they remain reluctant to alter securities registration requirements and exemption rules to mandate their use. The role for regulators is traditionally seen as protecting investors from fraud and assuring the integrity of markets, not as reforming the international financial architecture; this may be why officials are reluctant to go down this road. And while it has been suggested (by, *inter alia*, Taylor 2002) that the IMF might extend assistance to countries adopting such provisions at preferential interest rates, there are considerable obstacles to doing so, notably the provision in the IMF's Articles of Agreement that guarantees comparability of treatment for all members.

The Statutory Approach

Elaborating the provisions of loan contracts is in some sense the obvious way of addressing information, coordination and free-rider problems in a decentralized financial system. But some observers, such as Anne Krueger (2001) of the IMF, insist in addition on the need for a statutory framework – not a full-blown bankruptcy court but a legal framework that would bind all countries and supersede the conflicting provisions of private loan agreements, much in the way that Chapter 11 of the U.S. bankruptcy code supersedes the provisions of private loan contracts in the United States when a firm goes into bankruptcy. The most prominent proposals along these lines is Krueger's Sovereign Debt Restructuring Mechanism (SDRM); a comprehensive exposition of this proposal appears in Krueger (2002). One way of thinking about the competing proposals is that a statutory approach like the Sovereign Debt Restructuring Mechanism elaborates the traditional U.S.-style court-led approach to debt restructuring by relying on statute to create a quasi-judicial process for debt reorganization, while collective

action clauses attempt to extend the traditional English-style approach that relies on contracting and self-organizing creditors, with little if any court involvement.

Proposals for a statutory approach like a Sovereign Debt Restructuring Mechanism typically have four key features, which bear more than a passing resemblance to the central features of Chapter 11 bankruptcy. First, restraints on litigation would be imposed, perhaps after the approval of a supermajority of the creditors.⁴ Second, creditors could agree to assign seniority and protection from restructuring to new private lending, including the provision of trade credit, to reduce the dangers of a cut-off of foreign credit. Third, a supermajority of the creditors, regardless of the particular bond issue or loan obligation they held, could vote to accept new terms of payment under a restructuring agreement. Minority creditors would be bound by the decision of the majority. Finally, a dispute resolution forum would be created to verify claims, guarantee the integrity of the voting process, and adjudicate disputes.

Full implementation of the statutory approach would require amending the IMF's Articles of Agreement, which requires support from three-fifths of the members holding 85 percent of total voting power in the Fund. Obtaining the 85 percent super-majority necessary to amend the IMF's Articles of Agreement would be a formidable task. By design, the Articles of Agreement are difficult to change, for otherwise they would not provide an effective set of checks and balances on decision making in that institution. In particular, amendment requires the support of the U.S. government, which holds 17.1 percent of the votes, and ratification by the U.S. Congress. At the spring 2003 meetings of the IMF, it was acknowledged that there did not exist the requisite level of support for amending the Articles – in particular, the U.S. government failed to lend its support – and the SDRM was consigned to further study. To be sure, a similar

statutory approach could also be created by enacting legislation in each national jurisdiction. But if not all countries adopted the necessary legislation, the advantage of universality and uniformity would be lost.

Comparing the Contractual and Statutory Approaches

On what basis might one prefer this statutory approach to the contractual alternative? Comparisons of collective action clauses and statutory mechanisms emphasize their implications for four problems: asset substitution, aggregation, transition, and borrowing costs.

Asset substitution refers to the possibility that borrowers and lenders will substitute away from bonds with collective action clauses in favor of bank loans and other credit instruments where they are not included. As noted, an advantage of a statutory mechanism put in place by an amendment to the IMF's Articles of Agreement would be its universality -- in principle, it would cover all assets and countries. The proponents of collective action clauses do not agree, however, that their preferred solution is incapable of addressing the asset substitution problem; some like Taylor (2002a) propose that collective action clauses be added to bank debt as well as bonds, which could be done by modifying bank regulation and securities market rules. The proponents of collective action clauses also argue that if a few major markets alter their contractual provisions, borrowing is unlikely to shift to other significantly less liquid and more costly locales. Most issuers now prefer to issue global bonds that meet registration requirements in all major markets, as a way of maximizing the potential customer base (Roubini and Setser 2003). In particular, the size of the institutional-investor market in the United States makes it seem unlikely that the market will migrate away from that country.

The *aggregation problem* is that existing contractual provisions, even in the UK market, do not address the need for cross-issue coordination. Collective action clauses provide for a majority vote by the holders of an individual bond issue to modify the terms of payment due the holders of that issue, but they have no effect on the amounts due the holders of other issues. A statutory approach, by providing for one grand super-majority vote of all the creditors, would solve the problems of cross-issue coordination and inter-creditor equity at a stroke.

Those who prefer collective action clauses observe that, historically, the holders of different issues have been addressed problems of cross-issue coordination by forming representative committees. The international market in sovereign bonds was active in the nineteenth and early twentieth centuries, when there were frequent defaults and restructurings. Bonds were widely held, and countries had multiple issues in the market. Bondholders dealt with problems of cross-issue coordination by forming committees composed of representatives of various classes of creditors (Feis, 1930; Eichengreen and Portes, 1989; Mauro and Yafeh, 2002). The proponents of collective action clauses observe that there is again a tendency today to form creditors' committees --as in the cases of Argentina, Ecuador, Ivory Coast and Russia -- and argue that these can again be relied on to solve problems of cross-issue coordination.⁷ They also suggest that a Code of Conduct like that suggested by the Bank of France (2003) could be used to encourage information sharing among the holders of different bond issues and thereby discourage strategic behavior.

The *transition problem* is that even if statute in all countries is immediately changed to require all bond issues to include collective action clauses, time will still be required for these new instruments to work their way into the market. The IMF (2002b) has estimated that if all

sovereign bonds issued starting in 2002 include collective action clauses, but no existing bond are amended or retired, 80 percent of international sovereign bonds would include collective action clauses by 2010 and 90 percent by 2019. Market-based debt exchanges could be used to replace the existing stock of bonds with instruments that included collective action clauses, but it is not clear how enthusiastically the exchange offer would be received. How much one should worry about the speed of this transition is unclear. After all, proposals for getting collective action clauses into the market have been debated for at least eight years. Taking another eight years to get 80 percent of the way might therefore be regarded as a significant achievement.

The *borrowing cost problem* is that if measures like collective action clauses to make sovereign debt restructuring more orderly also make it more frequent, investors may be rendered reluctant to lend to emerging markets, which will find it correspondingly more difficult to fund their development needs. The rebuttal is that countries go to great lengths to avoid debt restructuring and that fears of borrower moral hazard are exaggerated. Consequently, creditors will appreciate having in place mechanisms that ease restructuring when sovereign debts are rendered unsustainable by circumstances not of the debtor's own making.

One might argue that the same reasons for why the cost of capital for corporations is not raised by the existence of a well-functioning domestic bankruptcy and insolvency code should apply to the case of sovereign borrowers as well. But this view may be too sanguine, because there is no equivalent in the sovereign context to the provisions in national statute that allow the courts to replace management and impose other sanctions on corporations that invoke bankruptcy opportunistically. In the corporate context, if the effort to reach a mutually acceptable compromise under Chapter 11 is unsuccessful, the result is a wind-up of the firm

under Chapter 7. The court as trustee takes over the proceeding. Under a statutory approach like the proposed Sovereign Debt Restructuring Mechanism, in contrast, the only result of unsuccessful negotiations would be the cessation of the temporary limits on private litigation. This difference could significantly tip the balance of bargaining power in the direction of the debtor (Cream, 2002).

Evidence on the Collective and Statutory Approaches

The bond market is the obvious place to look for evidence on the realism of these fears, since debt instruments including collective action clauses have historically been issued in London but not New York. The impact of contractual provisions on borrowing costs has been studied by Eichengreen and Mody (2000, 2001), Petas and Rahman (1999), Becker, Richards and Thaicharoen (2000), and Gugliatti and Richards (2003). For example, Eichengreen and Mody study more than 3,000 bonds, in principle the universe of all international bonds issued between 1991 and 2000 by emerging markets – corporate, municipal, state and sovereign alike. While this debt is issued by emerging market borrowers, it is denominated in developed country currencies. The bonds trade on a secondary market. Bonds can be classified according to whether they include collective action clauses, which those issued under UK law virtually always do, or whether they lack such clauses, like almost all bonds issued subject to U.S. law.

The key finding of the Eichengreen and Mody (2000, 2001) analysis is that low-risk countries pay a relatively *lower* interest rate if they borrow with collective action clauses, but high-risk countries pay a relatively *higher* interest rate if they borrow with collective action

clauses. An intuitive interpretation of this pattern is that more creditworthy emerging-market borrowers value their capital-market access and are unlikely to renege on their debt obligations. However, the fact that they can resort to provisions facilitating the orderly restructuring of their obligations is viewed positively by the markets. For less creditworthy borrowers, in contrast, potential lenders fear that collective-action clauses can encourage opportunistic default. Borrowers with low credit quality are consequently charged a premium for the privilege of including them.⁵

The precedent-setting \$1 billion of global Eurobonds issued by Mexico in February 2003, which featured collective action clauses despite being subject to U.S. law, can be used to gauge the plausibility of these results. The bonds, maturing in March 2015, were priced to yield 6.92 per cent, a spread of 313 basis points over 10-year U.S. treasuries. This compares Mexico's 2016 bond, without collective action clauses, which was yielding about 7.27 per cent. The Eichengreen and Mody (2000, 2001) results suggest that a country which just succeeded in obtaining an investment grade rating (Mexican debt was rated BBB-, its lowest investment grade rating, by Standard & Poor's, and Baa2, one step above the lowest investment grade, by Moody's) should have enjoyed a discount on bonds with collective action clauses of about 25 basis points.⁶

It is not clear how these empirical results would apply to a statutory mechanism for addressing sovereign debt. Krueger's (2002b) argues that the impact on borrowing costs of a procedure like the proposed Sovereign Debt Restructuring Mechanism should be similar to that of collective action clauses. That is, having a statutory procedure for more orderly debt restructuring should make claims on highly creditworthy countries even more attractive, since

they would not resort to the mechanism except in response to extraordinary circumstances not of their own making, while having in place a mechanism to resolve any crises quickly would be attractive to all parties. In contrast, less creditworthy countries tempted to act opportunistically might have to pay more.

However, a hypothetical statutory approach is not quite parallel to the already existing collective action clauses. Any statutory process would be new and unproven, which is likely to bring greater product uncertainty for a time. For example, investors who currently who currently hold debt instruments requiring their unanimous consent to any change in the terms of payment a would find themselves facing a situation with limits on litigation and various supermajority requirements, and they might worry the new regime was less respectful of their contractual rights.

Challenges for Policy and Research

The frequency of financial crises in emerging markets has focused attention on the limitations of existing approaches to crisis resolution. Some have emphasized the economic burden placed on emerging markets by the cost and difficulty of restructuring unsustainable sovereign debts. Others have pointed to the pressure felt by the IMF to provide financial assistance and the moral hazard thereby created for investors and governments, which in turn increases the likelihood of future crises. Both observations suggest the desirability of reform to make debt restructuring more orderly, efficient and predictable. “Sovereign credits are essentially junk bonds,” Bulow (2002, p. 234) has written, “and it is crazy to buy or sell them

without realizing that they are very likely to be restructured.” To this it may be added that it is crazy for officials and market participants not to insist on a statutory or contractual basis for such restructuring.

Various proposals for improving the process of sovereign debt restructuring have been made over the last decade. But no consensus yet exists on whether the best approach is to promote widespread use of collective action clauses, or to attempt a statutory mechanism, or for that matter to remain with the status quo. For scholars this suggests a series of questions to be pursued further in future work. How serious is the moral hazard problem? Can collective action clauses be added to bank loans and other credit instruments as easily as to bonds? Could market-based debt exchanges be used to retire debt instruments lacking collective action clauses, thereby speeding the transition?

Perhaps the most fundamental question is whether either the contractual or statutory approach will ultimately make the world a significantly safer financial place. Learning that Mexico’s February 2003 Eurobond including collective action clauses traded in New York at something like a 25 basis point discount compared to otherwise comparable issues, skeptics will naturally ask whether this evidence doesn’t simply confirm the Roubini (2001) view that such reforms are largely irrelevant. They will ask whether having Mexico, Argentina, Brazil or Russia borrowing in the 1990s at 25 basis points more or less really would have averted their financial crises. The answer almost certainly is no, but averting all financial crises is too demanding a criteria to set. Those who emphasize the deadweight losses associated with present arguments would observe that such innovations are a cheap – indeed, in some circumstances a costless – way of more smoothly and efficiently resolving such crises when they occur, and that

this is enough to make them socially attractive. Those who worry about the moral hazard associated with IMF lending will suggest, to the extent that the smoother resolution of defaults makes it “incentive compatible” for the IMF to resist the temptation to automatically provide emergency finance, that lenders will be quicker to draw back from countries with potential problems of debt sustainability, and that this in turn will prevent those governments from crawling so far out on an unsustainable financial limb. Not all financial crises will be averted, in this view, but a significant number might be.

A further question, posed by Lipworth and Nystedt (2001), is how the markets would adapt to institutional reform. If the authorities were somehow to require collective action clauses in all new bond issues, bondholders could demand larger issues to make it more difficult for a relatively small number of creditors to push through restructuring terms, or they could demand smaller issues to make it easier to assemble the 25 percent plurality needed to initiate legal action. If a Sovereign Debt Restructuring Mechanism did not apply to sovereign debt issued in domestic markets, as is commonly assumed, then markets might substitute such instruments for bonds issued in New York or London. These conjectures require further study. But their implication is that any innovation regarded as undesirable by lenders and borrowers will be circumvented, sooner or later. Only if the innovation is regarded as a Pareto improvement that was not previously achievable due to coordination problems, externalities, product uncertainty, or the structure of the financial industry is it likely to remain effective in the long run.

Finally, observers with reservations about collective action clauses or about a statutory approach like the proposed Sovereign Debt Restructuring Mechanism will want other alternatives. One possibility is innovative forms of debt: perhaps instruments that are indexed to

GDP or commodity-prices which automatically adjusted current debt-servicing obligations to overall economic performance or to the prices of key commodities (Borensztein and Mauro, 2002). But the question for the proponents is why, if these instruments really offer a superior combination of risk and return, they have not already been embraced by the markets? Perhaps these innovations have pitfalls that are more obvious to actual borrowers and lenders than to academic economists. Or perhaps they are another example of a productive financial innovation that is held back by the kinds of considerations mentioned earlier – product uncertainty, first-mover disadvantages, coordination problems, mismatches between private and social benefit, and political distortions – in which case there may be an argument for the international financial institutions to subsidize their use.

Another approach would be to impose hard limits on the size of IMF packages, restricting access in excess of normal limits to cases where the stability of the international financial system was clearly threatened. Not only would this step limit the moral hazard caused by IMF rescue facilities, but by making clear that bailouts were no longer on offer, it might speed progress on the implementation of voluntary approaches to facilitating sovereign debt restructuring, such as the more widespread of collective action clauses and GDP-indexed bonds (Haldane and Kruger, 2001; Goldstein, 2003). But if imposing presumptive limits on IMF lending is feasible as a first step, why has the official community not already moved in this direction in response to very considerable concern about the effects of moral hazard? One answer is that a commitment to hard lending limits would not be credible until there existed other ways of resolving crises at a socially acceptable cost – such as collective action clauses or an explicit statutory approach. After all, the international financial system is a set of interlocking

parts. No single reform may significantly improve its performance characteristics, or be feasible for that matter, in the absence of other, complementary reforms.

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Table 1
External Financing for Emerging Market Economies
(billions of dollars)

	1999	2000	2001	2002e	2003f
Current account balance	30.1	47.9	32.8	51.8	33.6
External financing, net:					
Private flows, net	148.2	185.6	125.7	112.5	137.1
Equity investment, net	164.1	149.9	144.5	101.9	116.6
Direct investment, net	149.1	135.6	134.3	106.6	107.7
Portfolio investment, net	15.0	14.3	10.2	-4.7	8.9
Private creditors, net	-15.9	35.7	-18.8	10.5	20.5
Commercial banks, net	-51.6	-4.4	-26.3	-4.8	-2.6
Nonbanks, net	35.8	40.1	7.5	15.3	23.1
Official flows, net	12.4	-3.0	14.7	12.2	10.4
International financial insts.	2.4	3.3	24.3	19.8	19.6
Bilateral creditors	10.0	-6.2	-9.6	-7.6	-9.2
Resident lending/other, net ^a	-135.4	-159.5	-85.7	-35.6	-60.6
Reserves (-= increase)	-55.3	-71.1	-87.5	-140.8	-120.6

Notes: e = estimate, f = Institute of International Economics forecast. Emerging markets include the principal recipients of capital flows in Eastern Europe (Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Turkey), Latin America (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela), Africa/Middle East (Algeria, Egypt, Morocco, South Africa and Tunisia) and Asia (China, India, Indonesia, Malaysia, Philippines, South Korea and Thailand).

^a Including net lending, monetary gold and errors and omissions.

Source: Institute of International Finance (2003).

Table 2
Stock of Outstanding Bonds by Jurisdiction
(end-2001)

Jurisdiction	Amount in percent of total	Amount in millions of U.S. dollars	Number of bonds (excluding Bradies for US) 1/
Austria	0.02	67	1
UK	24.05	85,182	156
France	0.30	1,060	4
Germany	10.13	35,864	89
Italy	0.03	105	1
Japan	5.85	20,716	59
Luxembourg	0.22	763	4
US	59.07	209,199	233
of which Bradies		73,837	
Spain	0.04	138	1
Switzerland	0.29	1,034	10
Total 2/	100.00	354,129	558

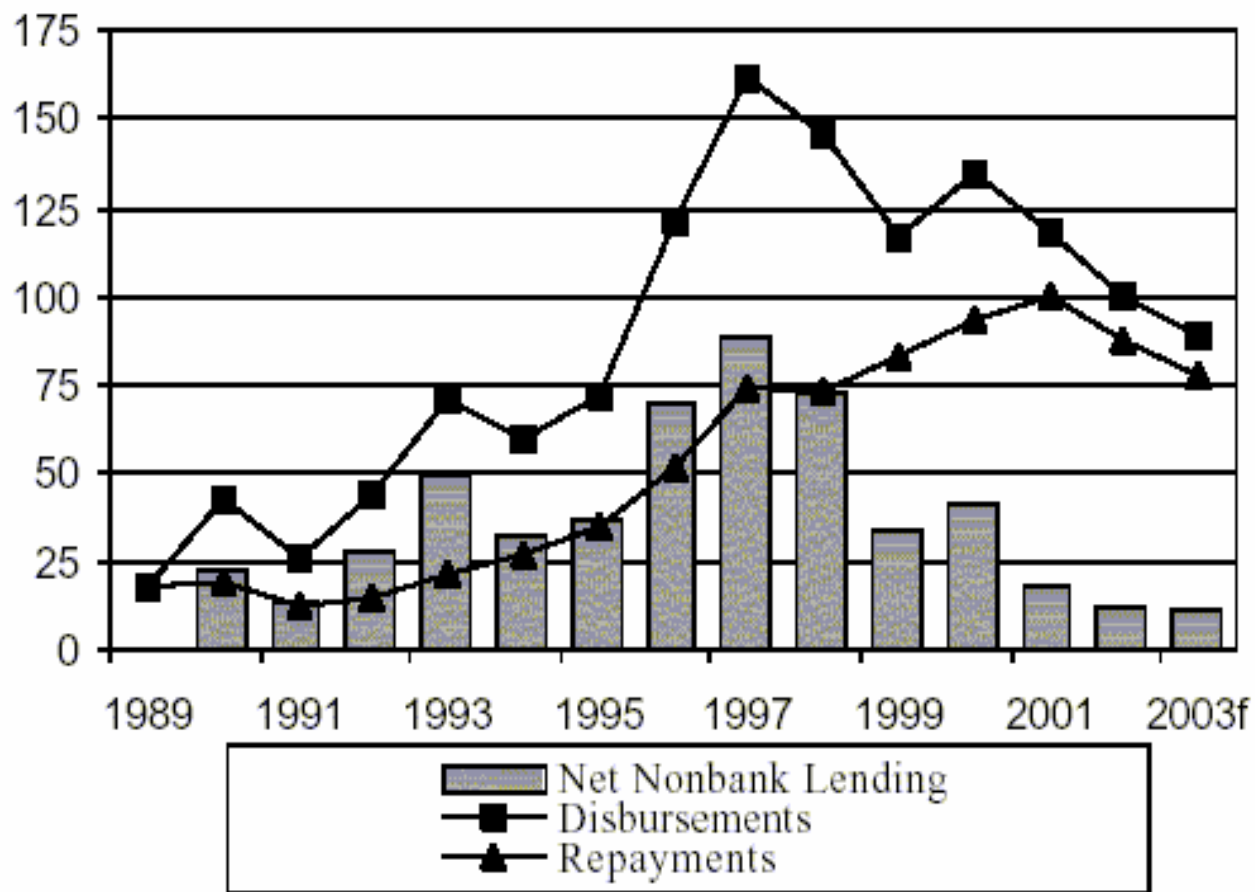
Source: Bondware Database and IMF (2002b).

Notes:

1/ Data include the aggregate amount of Bradies, but not the number the separate bonds.

2/ Data on jurisdiction were not available for two bonds accounting for the difference in totals.

Figure 1
Medium- to Long-Term Nonbank Lending to Emerging Markets*
(billions of US dollars)



*Excludes short-term net credits, interest rate arrears, and discounted debt transactions.

Source: Institute of International Finance (2003).

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Endnotes

¹ It may be relevant that in three of these four cases the debtor could use special circumstances and contractual provisions to encourage participation by the creditors and discourage holdouts. Ukraine's Eurobonds were held by a limited number of investment banks and hedge funds, facilitating dialogue and discouraging free riding. Three of four of those bonds included collective action clauses, which the country used to require holders accepting to the exchange to give their votes to an exchange agent who would act as their proxy at a bondholders meeting, thereby binding in nonparticipating holders. Pakistan's bonds also included collective action clauses, which it could threaten to use in a similar fashion, although in the end it did not have to do so. Ecuador used "exit consents" – it asked accepting bondholders accepting the exchange to alter the non-financial terms of the old bonds, removing cross-default and acceleration clauses, financial covenants, and limits on the country's ability to further restructure its bonds. The markets responded by adding to some subsequent debt issues prohibitions on the ability of a qualified majority of bondholders to alter non-financial terms. Thus, whether future exchange offers can work as smoothly in the absence of collective action clauses is an open question (see below).

² The effort to encourage "private sector burden sharing" or to "bail in the private sector," underway in official circles since at least the Asian crisis of 1997-8 (see Eichengreen 1999), was an attempt to devise a mechanism whereby private credits incur some losses despite the extension of an IMF bailout. Unfortunately, aspiring architects could not come up with a mechanism that would require bondholders to share in the losses, short of allowing the sovereign to default and then having the IMF "lend into sovereign arrears." We will see this in our discussion of the Argentine crisis, below. This is not to deny that other investors (those holding equity claims on the crisis country or with direct foreign investments there) suffer losses as a result of its financial crisis. Thus, the moral-hazard concern relates mainly to the inducement for bondholders to undertake additional investments in countries that are perceived as likely candidates for IMF assistance.

³ A recent study by Dell'Ariccia, Schnabel and Zettelmeyer (2002) summarizes this literature and argues that the decision to let Russia default constituted a "natural experiment" useful for testing for the existence of investor moral hazard. The decision to let Russia default, which was a departure from previous policy toward countries like Mexico and South Korea, implied a decline in the perceived probability of future bailouts, the authors argue. Investors should have responded by demanding a larger premium for holding risky credits, had the prospect of bailouts previously been affecting pricing behavior in the market. The authors find that spread compression declined significantly after August 1998, which suggests the existence of moral hazard effects due to IMF programs in the preceding period. But the authors' finding also implies that the severity of the moral hazard problem may have diminished in recent years.

⁴The immediacy of this threat of litigation is disputed. Some observers like Scott (2003, p.27) continue to warn that “the changes of holdout creditors collecting on their debts is a real one. This explains why sovereigns, like Peru in the Elliot cases, have generally paid off the holdouts.” Others such as Roubini (2001) have argued that the main instances where litigation has posed a threat have arisen as a result of ill-advised court judgements, which are unlikely to be repeated in the future. In response to this critique, the proponents of institutional reform have begun to attach less weight to this justification for official initiatives, implicitly acknowledging the validity of the skeptics’ arguments.

⁵In the case of Argentina’s \$111.8 billion of foreign bonds outstanding in 2001, 89 percent contained unanimous action clauses (whose inclusion is the practice not only in United States but also in Germany), while the remaining 11 per cent was issued in London, where drafting practice entailed the inclusion of collective action clauses (Bratton and Gulati, 2002, p.16).

⁶According to Pruitt (2003), the Finance Ministry said that the country took this action in order to make “an important contribution to strengthening the international financial system.” This same source notes that the U.S. Treasury issued a statement saying that the “United States strongly supports and welcomes Mexico’s decision.” The Mexican government then followed up this pathbreaking step by floating several additional issues subject to New York law but including collective action clauses.

⁷ The IMF proposal for a Sovereign Debt Recovery Mechanism is still evolving. Krueger initially envisaged a standstill on litigation that would be imposed for a limited period upon request by the debtor country and approval by the IMF. When spokesmen for investors objected that a ban on litigation, imposed and potentially renewed without their control, would represent a significant weakening of creditor rights and thereby discourage emerging market lending, Krueger (2002b) modified this to suggest that it should be possible to extend the stay beyond a specified limited time limit, say three months (the time required for the creditors to organize themselves), only with the agreement of a super-majority of creditors. Yet another revision suggested that provision for a standstill could be eliminated if the mechanism included a “hotchpot rule” – that any amounts recovered by a creditor through litigation would be deducted from its residual claim in a manner that neutralizes the benefits of litigation.

⁸There was still a need for official intervention to encourage the establishment of committees where they did not already exist – notably in countries that had recently acquired international creditor status but lacked the associated infrastructure, such as the United States – and to prevent fly-by-night committees from discrediting the operations of their more reputable counterparts. Thus, the British Corporation of Foreign Bondholders, originally founded in 1868,

was reorganized by an act of Parliament in 1898, while the Foreign Bondholders Protective Council was established in 1933 with encouragement from the U.S. State Department. Thus, the argument that a committee infrastructure may suffice to resolve aggregation problems does not necessarily imply that there is no need for government intervention. Indeed, some of the preceding arguments for why financial innovations may not be forthcoming, absent such intervention, may apply in this context as well. Responding to these concerns, the Institute of International Finance (2002) proposes official support for the creation of a Private Sector Advisory Group to facilitate information sharing, committee formation, and intra-creditor as well as debtor-creditor coordination.

⁹ Becker, Richards and Thaicharoen (2001) and Gugliatti and Richards (2003) do not find evidence that including collective action clauses raises borrowing costs for sub-investment-grade countries. If Eichengreen and Mody's findings are taken at face value, they suggest another reason why some emerging markets are reluctant to utilize these provisions – it would raise their borrowing costs. Whether policy reforms that increased the differential in borrowing costs between investment-grade and sub-investment-grade countries is desirable from a social point of view is a separate question. Given the extent of capital scarcity in low-income countries, there might seem to be a *prima facie* case that anything which makes it more costly for them to access foreign capital is undesirable. But if there are other distortions, like IMF lending, that artificially compress the spreads between high- and low-risk borrowers, a policy reform that works in the other direction may offset an existing distortion. In particular, rationing foreign finance to high-risk borrowers promises to reduce the danger of financial crises, which provides much of the motivation for the reform exercise. These issues are discussed at greater length in Eichengreen (2002).

10 The slightly different term to maturity of the two bonds complicates the comparison, since estimates of the yield curve suggest that investors will demand a few additional basis points to hold a bond with an additional year to run before it matures. And the fact that the relationship between the term of the bond and its spread is nonlinear makes the comparison more difficult still. 25 basis points are, after all, small compared to spread over Libor of more than 300 basis points on the typical Mexican issue. Thus, it is also possible for those like Becker, Richards and Thaicharoen (2000) et al. who conclude that there is no difference in how bonds with and without collective action clauses are priced to invoke the Mexican issue in support of their position.