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DEALING JUSTLY WITH DEBT

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Sovereign Debt Restructuring Proposals: A Comparative Look

*Thomas I. Palley**

A range of different solutions, as the contributions to this roundtable show, has been proposed regarding the problem of sovereign borrower insolvency. Two prominent factors need to be taken into account in assessing the merits of each proposal: its impact on economic efficiency, in particular on the supply and price of credit for developing countries, and its regard for considerations of justice and procedural fairness.

UNDERSTANDING THE PROBLEM

The last twenty years have been marked by significant changes in the pattern of international financial flows to developing countries. First, there has been a dramatic shift from official development assistance to private capital flows. Second, within private capital flows there has been a shift away from syndicated bank lending to bond lending. The former involves lending by groups of banks, whereas the latter involves issuance of bonds that may be held widely by multiple types of financial institutions and retail investors. This shift has given developing countries access to more capital and a richer menu of financing choices. However, access to more credit has also been accompanied by the buildup of overindebtedness, with negative consequences for credit markets and the global economy. As a result of the increased reliance on private-sector bond financing, financial markets may now have greater difficulty arranging debt restructurings at a time when they are needed more frequently.

The buildup of large debts generates a debt overhang that creates a permanent climate of financial fragility. Given this climate, lenders require higher interest

* For an extensive discussion of some of these issues, see also my paper, "The Economics of Sovereign Debt Restructurings: A Comparison of Competing Proposals and a Suggested Compromise" (Open Society Institute, 2003, unpublished). This essay has benefited from the comments of the participants at seminars held at the IMF, Washington, D.C., September 27, 2002, and January 22, 2003; the consultative seminar, "UN Financing for Development," United Nations, New York, N.Y., November 7, 2002; and the roundtable, "Dealing Justly with Debt," Carnegie Council on Ethics and International Affairs, New York, N.Y., April 30, 2003. The views expressed are mine, and not those of the Open Society Institute.

rates to compensate for risk of default, which raises the price of investment finance and in turn debilitates economic development. Existing debts also obstruct countries from obtaining new investment finance, even for projects that may have high marginal rates of return.

Countries' inability to restructure debt also has negative impacts on global credit markets. Under the existing system, the costs of default to a domestic economy are large, and countries have an incentive to "gamble for redemption"—take high-interest loans to repay pending ones, while hoping that something will happen that will prevent the escalation of debt and help them to avoid default. For their part, private creditors actively support this gambling by agreeing to lengthen repayment schedules in return for higher interest payments. The International Monetary Fund (IMF) also partakes in this process of gambling for redemption by extending loans to head off default. It does so because of the potential large costs for the global financial system, since default in one country can trigger financial crisis in another. To avoid these costs of financial contagion, the IMF often steps in to provide financing, thereby effectively bailing out private lenders. This adds another problem to the efficient functioning of credit markets—the moral hazard that prompts private lenders to factor expectations of a bailout into their lending decisions.

A second set of problems concerns the existing debt restructuring process. Currently, debt restructuring negotiations under the arrangements of both the Paris Club, which deals with debt owed to official-sector creditors, and the London Club, which deals with debt owed to private-sector creditors, are long and uncertain, and their outcomes are less than comprehensive. The lack of default protection for new lending during restructuring negotiations may result in under-provision of new financing that is necessary to fund investment, which drives economic growth. In effect, the current system has no equivalent for countries of debtor-in-possession financing under the private-sector bankruptcy code. Another difficulty is the collective action problem that arises because individual creditors have an incentive to act in their own perceived self-interest, which can result in collectively suboptimal outcomes. Thus, if one creditor holds out for full repayment during restructuring negotiations, or decides not to participate in them at all and instead files suit in court against the debtor, this may end up reducing the ultimate payment to each creditor. Still worse, the collective action problem applies not just within a specific creditor class, but also across creditor classes since different classes must agree upon the debt restructuring package. When development finance was provided through syndicated bank loans, the mentality and intimacy of the bankers' club prevailed, making it easier to negotiate loanrestructuring agreements. In addition, domestic banking authorities were able to exert subtle pressures to get banks to cooperate. This no longer holds given today's reliance on bond market financing.

STAYING OUT OF MARKETS

At one end of the spectrum of the proposed solutions is the private-sector view that the existing international credit markets are actually functioning fairly well. There is no significant collective action problem, and in many instances private creditors have been able to arrange debt restructurings efficiently. The only disruption is moral hazard created by the IMF's policy of bailing out countries with unsustainable debt.

However, this view is challenged by the recent experience in Argentina, which has suffered enormous income losses as a result of the deadlock caused by its default. Supporters of sovereign debt restructuring arrangements maintain that these losses could have been far smaller had a formal restructuring system been available. Their argument is that instead of entering a chaotic, prolonged default marked by the cutoff of international credit, Argentina would have been able to establish an orderly process that could have allowed for earlier normalization of relations with capital markets. This in turn would have reduced the scale of Argentina's recession.

Additionally, though restructuring of Ukraine's private-sector debts was accomplished, this restructuring was extended and difficult, which contributed to uncertainty that harmed investment and growth. Debt restructuring might have been accomplished with greater speed and less cost had a formal mechanism existed.

These cases attest to the fact that international financial markets have changed in ways that make restructurings more difficult to accomplish—hence the need for formal sovereign debt restructuring arrangements. Iraq offers the prospect of another instance where a sovereign debt restructuring might prove useful—and interestingly, most of Iraq's debt is official, which speaks to including official debt in the restructuring mechanism, as proposed by NGOs.

THE CONTRACTUAL SOLUTION

Another private-sector view, in partial recognition of these difficulties, is that international bond markets need modest tweaking in the form of introducing collective action clauses (CACs) into bond contracts. These clauses will bind all bondholders by the decision of a supermajority, thus allowing bondholders as a group to protect against individual holdouts.

CACs are a useful tool for improving collective action on the part of bond creditors, and they stand to facilitate debt restructurings. However, there is widespread agreement that they do not solve the core problems. In particular, CACs only bind holders of a single bond issue—hence the aggregation problem of binding bondholders across different classes remains. Nor do CACs address the problem of coordinating creditors across different jurisdictions where debt is issued. For instance, a country may borrow on the New York and London markets, and bankruptcy courts in the two jurisdictions may impose differential rulings. Further, absent binding international agreement or external pressure, debtors may be unwilling to issue new debt with CACs since creditors may view the clauses as weakening their rights and demand a higher risk premium. Finally, CACs would only apply to new debt that is issued with them. This leaves unaddressed the problem of the massive stock of already existing debt.

THE STATUTORY APPROACHES OF THE IMF AND NGOS

The IMF's Sovereign Debt Restructuring Mechanism (SDRM) and the NGO-endorsed Chapter 9 proposal both take a more comprehensive approach that envisions an institutional framework for resolving debt crises. They do so in the recognition that the dramatic changes in international financial markets render the existing system of ad hoc workouts ill equipped to address the negative economic and social consequences that arise from debt defaults. Despite this common feature, the two approaches have important differences regarding the details of the institutional mechanism. These differences result from disagreement over the economic consequences of alternative arrangements, as well as disagreement over the goals of debt restructuring. In particular, the IMF's perspective has always been one of improving capital market efficiency. Contrastingly, the NGO community has been significantly motivated by a desire to cancel corruptly accumulated debt of developing countries, which are poor and burdened by massive interest payments to rich countries.

The IMF's SDRM envisages a voluntary negotiation between the debtor country and its creditors, taking place in the Sovereign Debt Dispute Resolution Forum (SDDRF). A settlement would require a 75 percent supermajority approval by each class of recognized creditors. The details of these classes remain to be spelled out but could include official bilateral creditors (if official debt were included), privileged creditors, unsecured creditors, and a special optional class category that could be invoked in special circumstances if the structure of claims warranted it.[1]

From the IMF's perspective, market efficiency stimulates economic development, which promotes well-being. Hence it would be economically misguided and ethically wrong to push for reforms in a way that raises the cost and lowers the supply of development finance. The SDRM was designed with these considerations in mind, and there are significant economic benefits to it. First, since all private-sector debtors are involved in a coordinated manner, the restructuring procedure should be more orderly and accelerated, thereby reducing the economic damage that follows from default. Second, to the extent that it facilitates more comprehensive restructuring, it should help countries to escape the debt overhang problem and resume growth—which will benefit both the debtor country and the global economy. Further, with the available option of declaring insolvency and filing for bankruptcy, debtor countries would not have to gamble for redemption, and the IMF will no longer feel pressured to bail them out in order to avoid international financial contagion—which, in turn, would remove the moral hazard problem.

However, the IMF proposal explicitly excludes debts owed to the IMF and other multilateral institutions.[2] Consequently, debt restructuring within the SDRM stands to be incomplete, which stands to reduce the economic effectiveness of the SDRM. Further, the lack of an automatic stay on creditor enforcement may provide an incentive for individual creditors to pursue legal action outside the SDRM framework to obtain full value.[3] The absence of a stay also means that the debtor country will be formally in default if it ceases making payments, thereby preventing reversion to the status quo ante if the negotiations come to nothing—a feature that may give creditors a bargaining advantage in the SDDRF. Finally, the SDRM only gives legal standing to the debtor country and the creditors. It gives no standing to citizens either to express their views on the legitimacy of debts or on the particulars of any negotiated settlement. This is problematic given the prevalence of corruption and lack of democracy in many developing countries.

The Chapter 9 International Bankruptcy Court proposal, inspired by the section of the U.S. bankruptcy code that deals with bankruptcies of municipalities, rests on binding arbitration—in contrast to the voluntary negotiation of the

[1] International Monetary Fund, "The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations," November 2002, paras. 183–208, pp. 48–53; available at www.imf.org/external/np/pdr/sdrm/2002/112702.pdf.
[2] Ibid., paras. 188, 16, pp. 49, 9.
[3] The SDRM does allow for a stay of enforcement provided that 75 percent of the creditors consent.

SDRM.[4] As with the SDRM, the debtor would trigger the process by filing for bankruptcy. However, at this stage three judges would be impaneled—one selected by the debtor, another by the creditors, and a third by mutual agreement of the debtor and creditors.

The Chapter 9 approach has two major economic strengths. First, it explicitly includes all debts—official, private, and multilateral—potentially allowing for the full resolution of the debt overhang problem. In one step, the procedures of the Paris Club and the London Club, and that of the Highly Indebted Poor Countries initiative, are consolidated under one roof, and problems of aggregation are voided.

Second, it allows for citizen input during the initial debt verification stage, when citizens could request the invalidation of debts classified as odious—that is, debts for which lenders could have reasonably been aware were being incurred by internationally unrecognized regimes to finance expenditures that were not for the benefit of the people. The odious debt provision could potentially remove the significant economic efficiency losses that occur at present because of corruption and theft that benefits governing elites at the expense of country development. Knowing that loans could be disqualified in a Chapter 9 proceeding, lenders would have an incentive to lend only to honest regimes, and to monitor closely their loans to ensure that the funds were honestly used. Not only would such monitoring raise the rate of return on investments by ensuring that funds were properly spent, it would also counter the corruption and financing of conflict that have been so disastrous for economic development. Moreover, developing country governments would have an incentive to address corruption in order to gain legitimacy and lower their borrowing costs.

The Chapter 9 model explicitly gives standing to citizens' voices within the court process in two other ways: the entire process is intended to be fully transparent, with court proceedings open to the public, and citizens could conceivably be asked to approve the negotiated settlement by referendum. The IMF argues that this feature would place an unnecessary burden that would slow the debt resolution process; citizen input should rather be assured in the domestic process through which citizens elect and shape the agenda of their representatives to multilateral organizations. Although this may be true in theory, in practice many of the countries with serious debt problems do not have democratic governments or are young democracies with undeveloped institutions and civil society. As a result,

[4] The Chapter 9 approach was originally proposed by Kunibert Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face," *World Development* 18, no. 2 (1990), pp. 301–13.

the venues for citizen participation in their domestic policy processes are either absent or inadequate.

One significant cost to the Chapter 9 approach is that it represents a considerable alteration of creditor rights that could have major negative ramifications for the supply and price of capital for developing countries. The prospect of binding arbitration with debtors appointing 50 percent of the judges, and the possibility for odious debt cancellation, could frighten potential lenders. This could dramatically reduce the supply of credit to developing countries while raising the interest rate charged, at least in the short term until lenders learn to protect themselves against the risk of odious debt cancellation through due diligence and by application of restrictive covenants that ensure loans are used as intended.

A second difficulty concerns the development of an operational concept of sustainable debt. Such a concept is needed to guide the judges regarding the provision of debt relief. Though the notion of sustainable debt is clear in principle, in practice it is much harder to define.[5] Contrastingly, the SDRM proposal could be operational without a definition of sustainability because debt resolution is achieved through consensual negotiation between the debtor country and its creditors.

Finally, there is concern that the selection of judges discriminates against sovereign creditors. Whereas sovereign debtors get to appoint half of the judges, sovereign creditors are not given equal rights. This constitutes an asymmetric treatment of sovereigns, with sovereign debtors being given preferential treatment relative to sovereign creditors.

A MODIFIED SDRM

From an economic standpoint, the comprehensive approach of an institutional mechanism holds the promise of being effective in dealing with debt. From a political standpoint, creating such a mechanism will require wide support. An irreconcilable difference between the SDRM and Chapter 9 proposals concerns the distinction between voluntary negotiation and binding arbitration. However, in other regards the SDRM proposal can be modified to render it closer to the spirit and intent of Chapter 9.

The first important modification would be to include an automatic stay of creditor enforcement. This is important in order to protect debtor interests and

[5] For a detailed discussion of the different ways of defining sustainability, and the problems related to forecasting future economic growth, see International Monetary Fund, "Debt Sustainability in Low-Income Countries: Towards a Forward-Looking Strategy," May 2003; available at imf.org/external/np/pdr/sustain/2003/052303.pdf

to give creditors an incentive to negotiate in good faith within the SDRM process. The IMF dismisses the inclusion of this provision by claiming that, in practice, creditors will not have time to collect on any enforcement actions within the envisaged SDRM negotiation timeframe, making such a stay irrelevant.[6] However, if this is the case, then the IMF and the creditors should have no objection to its inclusion.

Second, to make the restructuring comprehensive and thus effective, and to assure that private and official creditors are treated justly, the debt owed to the official community and the IMF should be included under the SDRM. Exception should be made only for new, debtor-in-possession-style lending that the international financial institutions provide as vital finance to the debtor country while negotiations are under way. Indeed, there is a benefit to be derived for official creditors from a comprehensive approach: they would gain significant control over the process, particularly if official and private debts were put in one class. Because an agreement will require a 75 percent supermajority, official creditors, who would often hold more than 25 percent of the outstanding debt, would effectively hold a veto in many instances.

In addition to making for comprehensive restructuring, inclusion of IMF and multilateral institution debts would also nullify existing private-sector creditors' objections that they are being asked to bear all the burden of debt restructuring. Finally, including the debt owed to the IMF and other international financial institutions would contribute to improved market efficiency by removing the moral hazard. If these loans were not protected, the IMF's incentive to finance bailouts of overindebted countries would be significantly reduced.

[6] Moreover, under the "hotchpot" rule, any legal takings outside the SDDRF would be deducted from the creditor's entitlement under the SDDRF settlement. The hotchpot rule says that any funds collected by an individual creditor enforcement action in another jurisdiction shall be netted out of the share due that creditor in the jurisdiction where the bankruptcy case is being heard. As such it is a disincentive to individual creditor enforcement actions, which is why the IMF argues a generalized stay of enforcement is not needed.