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World Institute for Development Economics Research

Discussion Paper No. 2002/109

Bankruptcy Proceedings for Sovereign State Insolvency

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November 2002

Abstract

The paper examines the main issues involved in translating domestic bankruptcy procedures to the sovereign context. It considers some of the principles by which domestic bankruptcy procedures operate, and the extent to which they apply to international lending. Two recent proposals are considered in more detail, that of Krueger (A New Approach to Sovereign Debt Restructuring) and that of Pettifor (Chapter 9/11? Resolving International Debt Crises—the Jubilee Framework for International Insolvency). The paper also considers the question of the ex ante effects of a procedure which makes default less costly, and concludes that despite a negative impact on the ability to borrow, the overall welfare effect need not be negative.

Keywords: sovereign debt, bankruptcy, capital flows, Chapter 11

JEL classification: F34

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This study has been prepared within the UNU/WIDER project on the Sustainability of External Development Financing, which is directed by Matthew Odedokun.

This paper was presented at the project meeting in Helsinki, 23-24 August 2002.

UNU/WIDER gratefully acknowledges the financial contribution to the project by the Ministry for Foreign Affairs of Finland.

Acknowledgement

I am grateful for comments made by Matthew Odedokun, Mansoob Murshed, Léonce Ndikumana, Tony Addison, Robert Lensink and other project participants.

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Camera-ready typescript prepared by Liisa Roponen at UNU/WIDER
Printed at UNU/WIDER, Helsinki

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ISSN 1609-5774
ISBN 92-9190-344-2 (printed publication)
ISBN 92-9190-345-0 (internet publication)

1 Introduction

The recent proposal by Anne Krueger (2001) of a 'sovereign debt restructuring mechanism', or SDRM for short, has sparked a wide ranging debate amongst academics and practitioners concerning the merits or otherwise of formal legal structures for dealing with distressed debtors. According to Krueger, 'the objective of an SDRM is to facilitate the orderly, predictable, and rapid restructuring of unsustainable sovereign debt, while protecting assets values and creditor's rights'. It is argued that the shift from syndicated bank loans to bond finance that has taken place over the last 20 or so years has created a number of coordination problems when the sovereign country finds itself in payments difficulties. Not only are typical bond holders less involved in the economies concerned than were banks, but their diffusion means that it is very difficult for bond holders as a group to agree to any restructuring of debts. Free-rider problems, it is argued, are much worse than they were perceived to be in the 1980s, as single bond holders can 'hold out' in the hope of obtaining payment according to their original contract, or the hope of being bought out by other creditors, while the mass of creditors agree to a reduction in their claims on the sovereign.

The main purpose of the paper is to give an overview of the principal issues involved in translating domestic bankruptcy procedures to the sovereign context. In addition, I shall concentrate on two particular proposals, the one by Krueger, and the other by Anne Pettifor of the Jubilee Coalition. The paper will also consider whether a formal bankruptcy procedure would so reduce the costs of default that default rates would rise and in response lenders would restrict lending and/or increase risk premia. Some commentators argue that this would lead to a reduction in future capital flows to developing countries, and would ultimately be to the detriment of debtor country welfare.

Due to space limitations, we shall not discuss other than in passing the question of whether a less ambitious 'contractual' approach which would encourage the inclusion of collective action clauses in bond contracts, as put forward by John B. Taylor of the US Treasury (Taylor 2002), amongst others, might offer a more realistic approach to solving many of the problems associated with sovereign debt crises. Suffice it to say that countries already have the option of issuing debt under UK law, which allows such clauses to be included, including majority voting to prevent litigation by holders of a particular bond issue, and if this option is not being exclusively used then one imagines that there must be some reason for that.[1] To bring such an approach about, a degree of coercion is probably necessary.[2]

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[1] The Rey Report (group of Ten 1996) recommended their use, but this does not appear to have had much impact on their implemtation.

[2] A number of commentators have dismissed the plan almost out of hand; e.g., 'The US plan has superficial attractions but is unworkable' (*The Financial Times*, Leader, 4 April 2002: 24). Others see it as the right approach, but also take the view that the development of the Krueger proposal may act as an incentive for adoption of the clauses in loan contracts (see Miller 2002). Eichengreen (2002) argues that a 'Krueger-like' statutory process is probably required to implement this approach.

2 The analogy between domestic bankruptcy procedures and sovereign debt restructuring

2.1 Motivation

According to Eichengreen and Portes (1995), there are two main features of an efficient bankruptcy court. The first is that it should maximize the ex post value of the firm, while the second is that it should ensure that the bonding role of debt is preserved. The latter means that the bankruptcy procedure should not create incentives for debtors to resort to bankruptcy.

It is not clear that the logic behind either of these features carries over to the sovereign debt context.[3] Maximizing the ex post value of the firm may be interpreted in the sovereign debt context as a restructuring (and possible commitment by the country to an economic adjustment programme), in order to maximize the value of repayments to the creditors. To be sure, such a restructuring may also be in the interests of the country. But there is no compelling reason why the interests of the debtor country should not be given a higher priority. Likewise, making the bankruptcy process sufficiently painful for the debtor country in order to preserve the bonding role of debt, is not obviously ex ante very efficient. Even in the simplest model, with a risk averse country one would like debt repayments to take into account the circumstances of the country.[4] Preserving the bonding role of debt works against this. A very harsh bankruptcy regime (or the absence of a bankruptcy regime at all) may preserve the bonding role of debt, but it also may mean that countries which fall on bad times suffer unduly. It may actually be ex ante efficient to cut the costs or shift the terms or any bankruptcy regime in favour of the debtor country, to allow the country more insurance. The downside of this, however, would be that lenders would be less willing to lend. So there will be a trade-off.

Likewise, countries may be subject to 'debt traps' and extracting large repayments from them may imply that they remain stuck in the trap[5] (see Sachs 2002). Even if such a country were risk-neutral, it may be efficient to extract less repayment in states of the world where the country may be in danger of getting trapped at a low level, so that this can be prevented.

While one might then argue that the fundamental motivation for corporate bankruptcy law is partially at odds with what is needed in the sovereign debt context, there is no doubt that similar collective action problems arise in both cases, and it is surely here that the analogy is most useful. The first collective action problem can arise before a

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[3] Eichengreen and Portes had in mind corporate bankruptcy and analogies between Chapter 11 of the US code, and a bankruptcy court for sovereign debtors (although they came out broadly in favour of a contractual approach). The motivation for personal bankruptcy law, and that for municipalities, is different; see the discussion below.

[4] There have been attempts to introduce financial instruments contingent on relevant economic variables, such as commodity bonds, but these have not proven successful. Likewise the International Finance Corporation attempted unsuccessfully to create a market in put options to enable investors to limit their downside risk.

[5] There are a number of reasons given for the existence of a debt trap. It may, for example, be that there is some threshold level of domestic saving below which output is very low due to nonconvexities in production functions. Alternatively, the savings rate itself might fall towards zero at low levels of income.

standstill on payments or de facto default occurs, namely a creditor grab race. This has two elements. First, there may be a rush to the exits by creditors which can diminish the value of the assets of the debtor in the corporate case, and in the sovereign debtor case, can lead to severe economic dislocation.[6] A rush to the exits in the corporate context may lead to inefficiency because an otherwise profitable concern is closed down, and it can be argued that a similar scenario can arise in the sovereign debt context. In the latter, commentators have tended draw comparison also with bank runs. For example, Eaton (2002) uses a variant on the Diamond and Dybvig (1983) model to show how, if one creditor fails to renew its loan, then all creditors will do likewise. A very similar problem can arise over a failure to extend new financing (or roll over short-term loans), either to a corporate body, or indeed to a country. The (same) collective action story implies that creditors as a group may fail to extend new finance, even though it may be in their collective interest to do so. Second, a rush to the court house can ensue, with each creditor attempting to be the first to attach a claim to any assets.

The second area where the collective action problem is seen to raise its head, is in bargaining over restructuring. Here, problems include rogue creditors (such as the much cited case of Elliott Associates in the recent Peruvian Restructuring) who are prepared to sue in the courts for full payment.[7] At a less extreme level, in multi-party bargaining, there is a problem of 'hold-outs' who will not settle, even though the majority of creditors would agree to a package. A motivation for this behaviour may be the hope of being bought out by the other creditors, eager to resolve the negotiations, as indeed happens in practice. Asymmetric information about the future prospects of the country is also likely to lead to delays in bargaining (and can also rationalize why different parties will be prepared to settle at differing terms).

In both of these areas, bankruptcy legislation can resolve such collective action problems. A payments standstill and the stay on litigation can prevent a creditor grab race, and the agreement of a restructuring plan under (super)majority voting can overcome the problem of hold-outs. It should be noted that these are to preserve creditor value. Thus, for example, the stay on litigation is to protect creditors from the behaviour of other creditors. It is not entirely clear that they would work the same way in the sovereign context. A payments standstill, by 'bailing in' the private sector, might be to creditors' disadvantage, particularly if the alternative is an IMF 'bail-out' (see below). Stays on litigation and majority voting may weaken the overall bargaining position of creditors.[8] However the view that collective action problems are severe and in need of

6 Creditors attempt to withdraw funds from a problem debtor, selling their assets and converting local currency in to dollars. In response, countries often raise their interest rates to prevent capital flight and to shore up foreign exchange reserves. This causes great damage to the local economy. Firms with loans in local currency may be unable to pay higher interest rates, and likewise debts denominated in foreign currency will have risen with the fall in the exchange rate. Bankruptcies and other dislocation occurs in the local economy. Much of this damage may be difficult to reverse, even when interest rates fall back to previous levels.

7 The precedent it sets is debatable, despite a judgment in favour of Elliot at a lower court. However the fact that a settlement occurred implies that Elliot Associates had a chance of succeeding had the case gone to a higher court.

8 It is argued that during the 1930s defaults, majority voting allowed settlements to take place on terms favourable to the debtor countries, with private minority creditors being forced to accept these terms. This is the reason why US law subsequently denied the possibility of collective action clauses in bonds (see Eichengreen and Mody 2000).

being addressed by a formal mechanism has its critics. Roubini (2002) for example argues that collective action problems are not as severe in the sovereign debt as in the corporate context.

A rather different motivation for bankruptcy law is that it should provide a 'fresh start' to an insolvent debtor (e.g., Sachs 2002). This is not the primary motivation in corporate bankruptcy procedures, but is found in procedures for personal and municipal bankruptcy. In the case of personal bankruptcy, this is grounded in the autonomy of an individual, so that the debtor is essentially freed from future claims by the creditors. It should be noted that this aspect of bankruptcy procedure has nothing to do with collective action problems.

Finally, one motivation exists for a bankruptcy procedure in the sovereign debt realm which is normally, but not always, absent in the corporate or civic spheres, concerning the possibility of public sector bail-outs and the so-called moral hazard problem. The moral hazard problem in international lending is generally seen to be due to the problem that private lenders will lend too much, relative to the capacity of borrowers to repay, anticipating that if a problem should occur, the international community will provide bail-out funds. This idea partly appeals to the (very controversial) idea that the debt of the IMF and other international financial institutions (IFIs) is effectively junior to that of private creditors, contrary to the usual doctrine. The idea is that the private creditors will benefit from the bail-out, or in other words, that the IFIs will effectively subsidize the private creditors. Alternatively, if IFI debt truly is senior, so that IFIs do not provide a subsidy, the bail-out may still allow creditors to exit at a low cost, but leave the burden of repaying the bail-out on the debtor. This will still affect ex ante incentives if it is perceived that the debtor is more likely to pick up the tab in an adverse event. Assuming then that this moral hazard problem is important, a payments standstill, by freeing the IMF from the trap of having to bail out the country, may force creditors to realize that it is in their own interest to roll over the debt (i.e., force a 'bail-in'). It is argued that elimination of the moral hazard problem will lead to more appropriate levels of spending. This has been argued, for example, by Miller and Zhang (2000). The whole question of moral hazard created by bail-outs, and the need for 'private sector involvement', remains controversial and will not be addressed in detail here.

2.2 Bankruptcy models

We turn next to a very brief survey of some relevant aspects of different models for bankruptcy, mainly based on US law, which have received much attention in the recent debate (I will concentrate mainly on features which share some similarity with issues arising in a sovereign debt context).

Chapter 11 is the bankruptcy procedure most commonly appealed to in connection with sovereign debt bankruptcy proposals. Chapter 11 is the procedure for corporations, and in contrast to liquidation (Chapter 7), it allows companies to continue operating, the idea being that the value of future profits may be greater than the current liquidation value. Existing managers usually, but not always, remain in control of the company. Critical features of Chapter 11 are, first, an automatic stay which stops litigation against the company for the period of the stay. Second, interest on unsecured debt is not paid until the reorganization plan is settled. Third, new loans take priority over all pre-bankruptcy claims, and hence this makes obtaining new finance much easier. (This is

referred to as a 'debtor-in-possession financing'; if new finance were to be treated on a par with existing claims, it is highly unlikely that any new funding would be available since prospects for repayment would be so unfavourable.) A reorganization plan is adopted by a voting procedure: all classes of creditors and equity (as a single class) need to approve the plan, and by a super majority in amount (two-thirds). Critical in this process, is what would happen in the absence of a plan being agreed. The firm may be liquidated, in which case creditors are repaid according to the absolute priority rule so that the administrative expenses of bankruptcy are paid first, other claims such as taxes and outstanding wage come next, then unsecured creditors (possibly not equally if there are subordination agreements), and finally equity, if anything is left. (Secured creditors are outside of the priority rule, and may receive payment even when no other creditor does.) Alternatively, the judge may adopt the reorganization plan using a procedure known as 'cramdown'. This requires a 'best interest of creditors' test to be satisfied, but again the 'fallback' position against which this is measured is essentially what creditors would receive if the firm were to be liquidated.

Of course, attempting to use Chapter 11 as a basis for a sovereign insolvency procedure will be limited by the substantial contrasts between corporate debt and sovereign debt. Sovereign debt is, with few exceptions, not collateralized. This is also true of unsecured corporate debt. The difference is, however, that the latter still has a claim on the assets of the company in the event of bankruptcy, and must be repaid before equity receives any payment. Moreover, in contrast to corporate debt, sovereign debt has equal priority (with the principal exception of IMF and World Bank debt).

Another major difference is that corporate bankruptcy implies that management may lose control. Under Chapter 11 legislation, unless the management can come up with an appropriate reorganization plan, it risks being replaced, or at least having an alternative plan imposed upon it. This consideration is important for the incentives facing managers in the bankruptcy decision. (Chapter 11 is favourable to management by international comparison; under UK bankruptcy law, for example, replacement of incumbent management is more immediate; see below.) Of course, sovereign default can trigger a political crisis in which the incumbent government is replaced, so the incentives facing corporate management and country governments may not be so dissimilar after all. In both cases there may be a tendency to put off the evil day because of this. From the point of view of creditors, the difference is substantial however. A court appointee to oversee a corporate bankruptcy is expected to act in the interests of creditors. A new government in the wake of a financial crisis may well be of a populist variety which seeks to blame creditors for the crisis rather than act in their interests.[9]

Chapter 9 provides protection for public bodies 'insolvent or unable to meet its debts as they mature' (a more stringent test than that used in Chapter 11), and which have failed to work out a solution with creditors. Only the municipality can file (with the authorization of the state). Once a municipality files under Chapter 9, the court issues a stay against litigation by creditors. A crucial distinction between Chapters 9 and 11 of the US code, is that the former protects the governmental powers of the debtor and also

[9] Could a bankruptcy procedure include a stipulation that elections are called under certain circumstances? It seems that the legal, constitutional and political hurdles would be insurmountable. There would be some advantages to such a stipulation however; debtors would be less likely to file for bankruptcy opportunistically, and it might be a means for encouraging the development of democracy. A major drawback would be that debtors would have strong incentives to delay initiating the process.

individuals who are affected by any reorganization plan—public officials cannot be replaced, unlike corporate management. Another distinction is that only the public officials can offer a restructuring plan (or the judge). The court must be satisfied that any plan of adjustment is fair, equitable, and feasible, and also must be in the interests of the creditor. Being in the interest of the creditor means that they should get what they would reasonably expect in the prevailing circumstances. Adoption of a plan requires similar super majorities in voting as under Chapter 11.

According to White (2002), what happens if a plan is not adopted by vote is ambiguous (an observation she also makes about the Krueger proposal). The main point here is that under Chapter 11 legislation, the 'fallback' position is effectively that of liquidation (i.e., Chapter 7). This acts as the reference point in negotiations, and also in the cramdown procedure. In Chapter 9, however, this possibility does not exist, although there is a theoretical possibility (never used) for the bankruptcy judges to impose their own plan on the municipality. She also points out that Chapter 9 has only rarely been used, and consequently the law is underdeveloped.

In general, the important distinction that reformers would draw between Chapter 11 and Chapter 9, is that in the latter the municipality's provision of services to its citizens should not be unduly compromised. That is to say, the municipality can continue to make basic choices without interference by the creditors or the court. In addition stakeholders have the opportunity to voice their approval or disapproval of the debt reorganization plan. Both of these features, it is argued, should be linchpins of a sovereign bankruptcy procedure.

Finally, it should be added that there is another possible model for a bankruptcy court for sovereign debtors, namely one based on personal bankruptcy. In individual bankruptcy (Chapter 7 or Chapter 13) creditors do not obtain the maximum value feasible from the debtor, similar to Chapter 9 for municipalities. Under liquidation (Chapter 7), for example, creditors are paid out of the property of the bankrupt estate, and even then certain assets are exempt, such as a home up to a certain value. Crucially, remaining debts are then discharged, so that households are not required to devote future income to debt repayment. Debtors can also choose to file under Chapter 13, where they are not obliged to give up any assets, but must put together a plan in order to repay (at least a portion of) their debts over time. The relevance of personal bankruptcy law for the sovereign case, and particularly the idea of a 'fresh start', has been emphasized by Sachs (2002); see Section 1. Moreover developing country debt bears a close resemblance to consumer debt (Bulow 2002). First, default occurs in both cases when the amount of debt is relatively low in comparison to income—typically equal to only a few months' income. Second, in both cases, there is an expectation that default is likely, and this is reflected in interest rates which are high.

While the above discussion, and indeed most of the recent debate, has been conducted with reference to the US code, it should be noted that bankruptcy procedures differ markedly between countries. In terms of corporate bankruptcy, for example, Chapter 11 of the US code is thought to be debtor (management) oriented, in order to maintain the business as a going concern, even at the expense of the creditors. The board of the company has substantial rights to retain control of the business while a reorganization plan is being put together. In contrast, the UK code, for example, prioritizes the repayment of creditors' claims. Under the UK code, there are various possibilities but they have in common the transfer of control to an insolvency practitioner who

represents the interests of creditors. It is more difficult to draw lessons from the UK code for international bankruptcy procedures for the very reason that transfer of control is problematical in the sovereign context (see the discussion above).

3 Recent proposals

In this section we outline two proposals that have recently been made to introduce more formal bankruptcy procedures into the sovereign debt context.[10] These are the respective proposals made by Anne Krueger, deputy managing director of the IMF, and Anne Pettifor for the Jubilee Coalition. According to Krueger, there is need for a

> … framework offering a debtor country legal protection from creditors that stand in the way of a necessary restructuring, in exchange for an obligation for the debtor to negotiate with its creditors in good faith and to put in place policies that would prevent a similar problem from arising in the future ... (Speech to the annual meeting of the National Economists' Club, Washington, 26 November 2001).

Her view is that benefits of an orderly process include the prevention of a creditor rush to the exits (as discussed above, if each creditor believes that other creditors will attempt to liquidate their assets, then each will attempt to be first to do so), and in return, there will be a guarantee that the creditor is acting responsibly to restore solvency.[11]

Krueger outlines two key challenges that an SDRM should address. The first is that it should encourage debtors to behave 'in a manner that preserves asset values and paves the way toward a restoration of sustainability and growth'. The second is that, once the SDRM is triggered, there should exist incentives 'for all parties to reach rapid agreement on restructuring terms that are consistent with a return to sustainability and growth'. The latter quote suggests a limit on how much creditors should be able to extract from debtors. Elsewhere, however, it appears the aim of the mechanism is to allow creditors to extract the maximum sustainable payment from the sovereign.[12] This should however be done in the most efficient way, and should not be inimical to the growth prospects of the sovereign. The sovereign should benefit from the mechanism, because unsustainable debt burdens will be addressed at an earlier stage than is typical currently (it is argued, as in the case of Argentina recently, that current arrangements

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[10] The idea of a bankruptcy court for sovereign debtors is not new. In fact it goes back to Adam Smith. See Rogoff and Zettelmeyer (2002) for a history of the idea. The paper by Sachs (1995) partly reignited the debate.

[11] A number of commentators have, however, described such a guarantee as non-credible

[12] At least this is implicit in Krueger (2002), where it is noted that corporate bankruptcy procedures serve to maximise the value of creditor claims (p.11). In qualifying how corporate procedures might be translated into the sovereign debt context, this point remains unqualified. On the other hand she notes that in some respects Chapter 9 for municipalities might be of more relevance, which suggests other priorities. Also ideas such as debt sustainability and restoring growth to the debtor probably reflect her view of the limits to what can be paid by the debtor. A further point is that, as discussed elsewhere in the paper, the Chapter 11 procedure is actually generous to debtors by international comparison.

encourage sovereigns to put off the evil day of reckoning as long as is possible, in order not to upset creditors). Consequently, foreign currency reserves will not be dissipated to be extent they are currently, and of course a faster restructuring will allow the sovereign to return more rapidly to normal relations with potential investors.

Krueger (2001) identifies the following core features that could be included in what she terms the 'sovereign debt restructuring mechanism' (SDRM). The mechanism is intended for use only when the debt burden is clearly unsustainable. Consequently, it is relevant only in situations where a significant reduction in the sovereign borrower's debt is required, and it is not relevant in situations where a temporary liquidity problem arises, requiring no more than a rescheduling of obligations. First, the process would exhibit majority restructuring. This would imply that a qualified majority of creditors could assent to a restructuring agreement, despite the objections of any dissenting minority. This would deal with the problem of hold-outs in the restructuring process. Second, there would be a stay on creditor enforcement. If an agreement had not been reached prior to a default, a temporary stay could be granted on creditor litigation after a suspension of payments but before a restructuring agreement is reached. This would prevent a grab race from developing. As Krueger points out, the incorporation of qualified majority restructuring, as just described, might very well increase the risk of a grab race ensuing since creditors will have less leverage once an agreement is reached. The next important feature she lists is protecting creditor interests. To reassure creditors that their interests are being protected during a period of a stay, the debtor would be required 'not to make payments to non-priority creditors'. Moreover, some guarantee that the country was following responsible economic policies would probably be required. For example, the country might be implementing an IMF programme, or at least it may have to obtain support from the IMF that it is behaving in an appropriate manner. Finally, there is priority financing. An SDRM could facilitate the provision by creditors of new financing by making such financing senior to all pre-existing debts. This is analogous to a 'debtor in possession financing' envisaged under Chapter 11 of the US bankruptcy code. Without such priority, creditors have little incentive to provide new finance, even if it is in their interests collectively to do so.

The idea of an SDRM is aimed at commercial debt in middle-income countries. It is not meant for the very low-income countries, the argument being that they are already being dealt with under the HIPC initiative. (By contrast, the bankruptcy process envisaged by the Jubilee coalition would apply to all countries that have difficulty servicing their debt.) An important distinction between the two groups is that the vast majority of the debt owed by the very low-income countries is official debt, while this is not the case for the middle-income countries. Consequently, the design of the SDRM is primarily aimed at the restructuring of commercial debt. Indeed, the claims of IFIs would not be subject to the mechanism (Krueger 2001), as they are treated as being senior by the international community. The issue of whether bilateral debt should be subject to the mechanism is left open. (In contrast, the Pettifor proposal would apply to all types of debt, including that owed to IFIs.) Essentially there are two options. First, if bilateral debt is excluded, then there would be a parallel, but independent, Paris Club process to determine the extent of bilateral debt restructuring. Comparability of treatment and coordination between the two processes might be problematic. Second, if official debt is included in the SDRM, then the suggestion in IMF (2002) is that it should be as a separate class, in analogy with the treatment of different classes of creditor under Chapter 11, so that each class may be treated differentially, but equally each class has a veto over the whole agreement. A drawback of this is that it would dispense with the

Paris Club, a well-developed procedure for dealing with official bilateral debt, with an expertise built up over many years.

One practical issue is the treatment of domestic debt.[13] Inter-creditor equity may demand that it is not just external holders of debt who agree to a reduction in claims. Should the claims of resident investors also be subject to the majority restructuring provisions of the mechanism? This is left open. A restructuring which affected asset values in the local banking sector, for example, could precipitate (or exacerbate) a banking crisis, and thus there may be strong arguments for excluding at least some elements of domestic debt. Domestic debt could be brought in, again, as a separate class (hence potentially subject to differential treatment), holding a veto over the whole process. The drawback here is that introducing too many classes of debt can bring back some of the coordination problems which the procedure was designed to overcome.[14] However, even the definition of domestic debt is fraught with difficulties. Should its definition depend on the residence status of the creditor, the currency in which the instruments are denominated, or even whether the governing law is domestic or not? In IMF (2002) the latter seems to be preferred.

Other open questions include the question of who can initiate a standstill. While initially it was assumed that IMF approval would be required, later versions toned this down, and in IMF (2002) it is assumed to be left as a unilateral decision of the sovereign. The later versions also play down the role of the IMF elsewhere in the process. This is in response to a widespread reaction that the IMF, itself a creditor and having political masters that may be influenced by other creditors,[15] may not be regarded as impartial.[16] Also, if exchange controls are imposed, should legal protection be extended to solvent firms prevented from servicing their debts?

What of the legal side? Introducing collective action clauses probably needs changes in national law requiring their use in all bond contracts. It is also generally thought that the full-blown Krueger approach would require changes to the IMF's Articles of Agreement. The idea would be that the class of contracts covered in Article VIII could be broadened to include all contracts. Then, if the IMF approved the suspension of payments on debt, the debt contract would be unenforceable in the courts of any IMF member. See also Greenwood and Mercer (1995) for discussion of other possibilities, including a separate international treaty.

Objections to the Krueger proposal include the following. It is not obvious that it identifies the problem correctly. The general move towards bond finance does not necessarily mean that restructurings have become more difficult than they were in the days of syndicated bank lending (see Roubini 2002). The possibility of precluding

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[13] Such issues need to be addressed by any formal bankruptcy mechanism.

[14] Whether bilateral debt and domestic debt should be formally included in the SDRM is arguably not a vital matter given that restructuring of either is possible outside of the SDRM without the same issues arising that might affect commercial debt issued under other jurisdictions.

[15] Commercial creditors were worried that the official creditors would avoid taking a 'haircut', while for debtors, having a creditor overseeing the process is unsatisfactory.

[16] Interestingly, both of these aspects are part of the proposal made by Pettifor (2002), and there does appear to be some convergence between the two proposals, including a recognition by the IMF of the need for civic involvement in the consultation process.

litigation against the debtor, even for a limited period,[17] is much stronger than what would result from a contractual solution which incorporates collective action clauses. The latter does not prevent creditors from suing, provided a sufficient majority is in favour. The Krueger proposal is therefore very favourable to debtors, and the possibility of opportunistic behaviour would need to be minimized. Moreover, the idea that the IMF should activate a standstill is controversial, although this has been downplayed in later versions of the proposal. Debtors may see it as diminishing their powers to act in a crisis; creditors, who are already distrustful of the motives of the IMF, will not want to see it granted extra powers. More radical critics object to the exclusion of certain types of official debt.

A rather different approach is taken by Pettifor (2002), based on the work of Kunibert Raffer (1990) who argues in favour of using Chapter 9 (rather than Chapter 11) as a model for an international insolvency court. Raffer claims that it would be relatively straightforward to implement this idea. International treaty arrangements on an ad hoc basis would be adequate. There are two main precedents for this. The first was the agreement of 1952 whereby the German government negotiated a 50 per cent debt reduction relating to its Versailles and Nazi era debts. The second precedent was a similar cut in Indonesian debt, in 1969. Ad hoc courts with a small number of arbitrators could be appointed. In each instance, members of the court would be appointed by the parties involved.

Pettifor envisages that the process would apply to all indebted nations, hence including the HIPC countries. The bankruptcy court would be constituted as an ad hoc body, with appointees nominated by the debtor and creditor, with a judge agreeable to both sides. The independence of the court is fundamental. There is emphasis on a process of ascertaining whether debts were contracted legitimately.[18] As in Chapter 9, parties affected can participate in the process, and this is given prominence in the proposal. Citizens will be able to have their responses heard. The guiding principle is to be justice, including the protection of fundamental human rights, in addition to the rights of creditors. The debtor should emerge from the process 'with reasonable prospects of financial stability and economic viability'. An appealing feature of this proposal is that it is in line with current international policy thinking on grassroot participation ('bottom-top approach') and ownership of economic policies.

While it shares with the Krueger proposal an automatic stay on debt payments, and recognizes the existence some of the collective action problems which Krueger emphasizes, the motivation is rather different, appealing to justice and the protection of rights. The process should allow the sovereign to escape from illegitimate loans and irresponsible behaviour on the part of both lenders and borrowers. Implicit also is that debt relief is likely to be more substantial than under the Krueger proposal where a return to debt sustainability only is suggested.

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17 Under the proposal in Krueger (2002), extension of a stay beyond 90 days should require the assent of a committee of creditors.

18 This may appeal to the idea of 'odious debt' where a state may justifiably repudiate debts incurred by tyrants no longer in power (see Kremer and Jayachandran 2001).

A weakness common to both proposals is that it is not fully clear what happens in the case of disagreement. In the Pettifor proposal, the court will mandate the final composition plan:

> The court would have to bind all creditors, and the debtor, to a debt reduction agreement which is 'fair, equitable and feasible' (Pettifor 2002: 10).
>
> It must be in the best interest of creditors—which is tested by what they could reasonably expect to be paid' (Pettifor 2002: 16).

At various points in the Pettifor proposal, there appears to be an implication that affected citizens should have the power to block a composition plan. Moreover the United Nations is supposed to ensure that any plan preserves fundamental human rights. Under Chapter 11, because the alternative to an agreement is liquidation, a fairly clear process is identified involving voting by creditors, even in the case where there is no agreement on a proposal. Moreover, if the judge has to act, the alternatives before him or her are clear. As already mentioned, this is not the case under Chapter 9 and there has not yet been a case under Chapter 9 where the judge has had to impose an outcome. In the sovereign case, it seems even likelier that the situation would be substantially more difficult to resolve by unilateral action of the court.

A further common problem is the question of debtor moral hazard. There are two main elements. First, a debtor might take unnecessary recourse to bankruptcy if it perceives this to be in its interest. It is acknowledged that insolvency is particularly difficult to both define and verify in the sovereign debtor case, and consequently it may be difficult to discern opportunistic behaviour from genuine need. It may be that the vagueness of what happens in the case of disagreement, discussed in the previous paragraph, is useful in this regard. If there is a sense among creditors that the debtor is being opportunistic, then they are unlikely to be prepared to accept substantial debt relief. An explicitly defined procedure might, on the other hand, allow the debtor to force large concessions out of the creditors. Second, the prospect of a less costly default might induce behaviour on the part of the debtor which increases the likelihood of default.

A criticism of the Pettifor proposal as it applies to the HIPC countries is that donors might be forced by the court to grant debt relief, but they could often simply offset this by cutting future transfers. Birdsall and Williamson (2002) argue that donors would never lock themselves into an approach that would coerce from them additional net transfers. In general, the political feasibility of the radical Pettifor proposal is open to question given the resistance that even the relatively conservative Krueger proposal is meeting.

The political hurdles to be overcome by any procedure are, of course, formidable. For example, the US alone can block any amendment to the IMF's articles, and has so far not shown enthusiasm even for the Krueger proposal. In principle one might think debtor countries should not oppose such a mechanism as it is optional. However, as a formal procedure would presumably replace current less formal mechanisms for dealing with crises, the calculations may not be so simple. In addition, concern has been expressed by stable middle-income countries that they might be tarred with the same brush as less viable countries: if default truly is easier/more attractive under a formal

procedure, then their credit rating might be downgraded by the existence of the procedure.

4 The costs and benefits of reducing the costs of default

The critical reaction by the creditor community to proposals for an international bankruptcy procedure reflects the presumption that default costs will be reduced, and moreover by weakening the position of holdout creditors, the bargaining power of creditors as a whole might be attenuated. Indeed, even though the Krueger proposal goes to great lengths to reassure creditors that their interests will be protected, it is an avowed aim of the SDRM to reduce the costs imposed on the debtor. The process is supposed to be, in the event of a restructuring being required, ex post efficient. However, this might lead to ex ante inefficiencies, even if creditors are not themselves worse off ex post. A reduction in default costs may make default more likely. This in itself may introduce inefficiencies, depending on whether there is too much or too little default under the current arrangements. Assuming that more frequent defaults are anticipated, lenders will lend less and/or charge a higher risk premium,[19] to the possible detriment of the developing world.

As argued above, it is not a priori clear whether there is too much lending or too little. A point made by a number of commentators is that the erosion of sovereign immunity may have made borrowing too easy. The use of UK and US law, and the legal infrastructures of other developed countries, by weakening sovereign immunity, might well imply that developing countries can borrow more than would be possible if all borrowing took place under the jurisdiction of their own courts. This is argued by Bulow and Rogoff (1990) and reiterated recently by Bulow:

> The US should repeal the relevant portion of the Foreign Sovereign Immunity Act Return of 1974 and the UK the part of the 1976 State Immunity Act that allows developing countries to waive their immunity when they borrow money abroad. That is, the entire jurisdiction over any sovereign's debts would lie in its domestic legal system. The other leading economic powers should follow suit, though unanimity would probably not be needed (Bulow 2002: 2).

Using the jurisdictions of developed countries allows sovereigns to raise more money than they could manage otherwise to raise. This is particularly relevant, if, as argued by the more radical critics of the current international financial architecture, many

[19] There is some evidence that these effects exist in the personal bankruptcy sphere, which, as argued above, shares some similarities with sovereign bankruptcy. Because exemption limits under Chapter 7 (liquidation) of the US code vary across states, it is possible to guage the effects of relatively generous limits. Gropp *et al.* (1997) show that households in the bottom part of the asset distribution hold less debt as exemptions become more generous, suggesting that there is a credit supply effect. Moreover they pay higher interest on automobile loans. There is scant evidence in the sovereign context, although a study by Eichengreen and Mody (2000) found that countries that issued debt under UK law rather than under US law pay a higher interest rate on average if their risk rating is high, although in fact the opposite is the case for countries with a lower risk rating. Because it is easier to restructure under UK law, this might suggest that for problem countries, an efficient bankruptcy procedure will add to interest costs. However, there might be a signalling effect; see below.

developing countries will attempt to borrow too much because the sovereign decision maker's interests do not coincide with those of the rest of the country. (This may be due, for example, to corrupt rulers siphoning off some of the borrowed funds, self-serving elites who do not suffer the full costs of repayment/default, or decision makers who serve interest groups but who anticipate that the costs of repayment will fall more heavily on other interest groups; see Alesina and Tabellini 1989, for a model of this latter type.)

A similar point can be made about the choice between UK and US law. Issuing bonds under UK law, with its collective action provisions, might be seen as a way of improving efficiency if a default occurs further down the line. The fact that countries prefer not to do this in general ore at least exclusively, but use US or other jurisdictions, might be seen as an indication that they want to increase the disruption that might occur if they end up in difficulties.

How should we interpret the fact that sovereigns appear to prefer to make default more costly? This might be because increasing default costs is genuinely a good idea, even if this is achieved by making the legal position murkier, because it allows the country to borrow more. If this view is correct, we might indeed worry that reform attempts are going in the wrong direction. Or, it might be that sovereigns are irresponsibly attempting to overborrow, as just discussed. A third possibility is that there some 'signalling' going on here. A country that refuses to waive sovereign immunity would be signalling that it anticipates a likely default. The equilibrium is a pooling one in which all types, those who are not likely to default and also those who are, choose to waive immunity (or issue under US law), in order to reduce borrowing costs. The signal is uninformative but the equilibrium would be inefficient because of the increased default costs for the latter category.[20]

Overborrowing can also occur because of informational asymmetries. Kletzer (1984) showed how, if creditors are unable to monitor the total amount of lending to a country, then the country will borrow more than would otherwise be the case. The intuitive argument is that while the country would prefer to commit to a lower level of lending, which would entail a lower level of default, and hence a low risk premium, this outcome is unsustainable when lenders cannot observe total lending. Starting from this putative equilibrium, with a low risk premium, the country would prefer to borrow more, and anticipating this, lenders will charge a higher risk premium. Nevertheless, in equilibrium there will be higher lending and a higher default risk than would be the case with the observability. The country is worse-off.

To summarize: if it is true that there is overborrowing then a sovereign bankruptcy procedure, assuming it makes default less costly (see below), is likely to improve matters by making lenders more cautious. The opposite may be true if there is underborrowing, as one interpretation of the use of foreign jurisdictions (especially the use of US law) in international lending suggests. Even in this case, however, if the procedure reduces the deadweight loss involved in default so that the lowered debtor costs are not at the expense of creditors, lending terms may not deteriorate unless the probability of default rises.

20 Indeed it has been observed that countries with some question about their debt sustainability do seem to issue debt under US law.

4.1 Will a bankruptcy procedure lead to more default?

Any bankruptcy procedure, even of the Krueger type, is likely to make default less costly. There are a number reasons for this. First, new (i.e., post default) lending would be easier to come by under the proposals, as already discussed. Second, the resolution of collective action problems might tilt bargaining power in favour of the debtor: those creditors attempting to hold out for the best deal can be outvoted by a (super) majority of the others. Likewise rogue creditors will have less power to extract payment. The temporary stay should reduce the chances of a currency crisis developing.[21] By reducing the moral hazard problem (see Section 1), the creditors may be forced to take larger losses, with the debtor not being left having to repay further loans to the IMF. Finally, a faster, more orderly process will surely reduce costs of disruption to the local economy.

Anne Krueger (2001) herself denies that this will create an increased likelihood of default:

> … some commentators fear that alleviating the collective action problems will make default an easy way out. But the prospect of economic dislocation, political upheaval, and possible long-term loss of access to international capital markets will still make countries loath to default on debt service obligations in all but the most extreme circumstances.

The Krueger view seems to deny the possibility of opportunistic behaviour on the part of countries, regarding payments crises as exogenous events.[22] This opinion does not appear to be shared by the financial community. For example, William Rhodes (senior vice chairman of Citygroup, Citicorp and Citibank) argues that the main concern of a number officials in emerging markets countries is that the existence of a formal bankruptcy mechanism, whether invoked or not, would cause uncertainty in the markets, deter potential lenders and investors, and drive up the countries' borrowing costs.[23]

John Taylor has expressed a similar concern that any reform should beware of opportunistic behaviour: 'Most importantly, any proposals should in no way 'disincentivise' a government from paying its debt' (Taylor 2002).

While, then, there is considerable disagreement on this matter, the point should be made that a cut in the bargaining power of creditors due to a formal bankruptcy process, will lead to increased risk premiums and lowered borrowing capacity independently of the question of whether the rate of default is likely to rise. And even if capital flows do fall, it may still be a price worth paying for better outcomes for debtors in bad states.

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[21] For a sketch of a model in which standstills can ex post benefit debtors at the expense of creditors' interests, see Eaton (2002).

[22] Even if opportunistic behaviour is absent, if the bankruptcy procedure leads to larger debt write-downs, lending can fall and interest rates rise as banks anticipate lower repayments.

[23] According to William Rhodes, 'The drawbacks for plan orderly rescue: they formal bankruptcy procedure for countries facing economic crisis would be inefficient and damaging' (The Financial Times, 22 March 2002: 13).

4.2 Concluding comments

The paper has presented an overview of the principal issues involved in translating domestic bankruptcy procedures to the sovereign context. While the collective action problems inherent in sovereign insolvency are addressed by proposed bankruptcy procedures, there remain important differences between proposals on the question of whether there should be a radical write down of debt or whether the mechanism should merely aim to restore debt sustainability. Of the two proposals considered in some detail, there remains a considerable vagueness about what happens in the case where agreement cannot be reached by the parties concerned. The paper also considered the question of the ex ante effects (in terms of whether future capital flows to developing countries would be deterred) of a procedure which makes default less costly, and concludes that despite a negative impact on the ability to borrow, the overall welfare effect need not be negative. Nevertheless, the model appealed to by the more conservative proposal of Anne Krueger, Chapter 11 of the US code, is itself a generous one to corporate debtors by international comparison. It was argued that translating that to the sovereign context may enhance the pro-debtor effect. Whether this is desirable or not, depends on whether more favourable treatment of debtors in default states is a price worth paying for tighter borrowing constraints.

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