WHAT TO DO WITH BANKRUPT SOVEREIGNS?

Some Theoretical Aspects of Solving Financial Crises

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Introduction

The liberalisation of capital movements and the increase of cross-border private capital flows in the past decade have led to a rapid development of international capital markets, but have also caused a number of financial crises. Although several international organisations, including the International Monetary Fund (IMF) are busy preventing economic and financial crises, these cannot be avoided entirely. The present article brings a short survey of the development of theoretical concepts of solving financial crises. The general principle is that each crisis has to be solved as quickly and painlessly as possible for the parties involved as well as for the functioning of international financial markets.

Financial crises are usually caused by the temporary shortage of liquidity and can be solved without resorting to extreme measures. However, there are also deeper crises that stem from excessive borrowing. The problem is particularly acute in developing countries where high need of domestic investments and shortage of local capital force businesses and governments to borrow from abroad. In such a case, domestic insolvency law applies only to businesses and not to governments. Careless borrowing can reduce government solvency at one point to such a level where debt servicing – repayment of interests and principal – becomes too big a burden for the country and it has to suspend repayments. In that case, the only way to solve the problem is for both, the debtor and the creditors, to understand the rationality of changing the debt burden and reducing it, if necessary, or in other words, restructuring the debt.

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Recent years have been extremely complicated for international financial markets. There are several reasons for credibility loss, but it should be stressed that internal problems of developing countries, both political and economic, have become most important among these reasons. Problems with servicing sovereign debt in Turkey, Brazil and Argentina, as well as in some other developing countries serve as a suitable example here. While the problems in Turkey and Brazil can be called liquidity crises, then in the case of Argentina we are dealing with sovereign bankruptcy.

Figure 1 brings a survey of the changes in the Emerging Market Bond Index EMBI+ calculated by JPMorgan Chase and differences in the interest rates of countries included in the index as compared against the interest rates of developed countries. Argentine bonds currently account for only 2% of the total emerging markets' bonds (prior to the September 2001 crisis, their share amounted to 20%). Bonds issued by Mexico, Russia and Brazil currently account for nearly 60% of all emerging markets' bonds. In addition, Figure 1 also shows the duration of the credibility crisis that has hit the emerging markets – after the 1998 financial crisis, the risk level of Russia, for example, did not drop until the year 2000. By way of comparison: the interest rates of Estonia's only Eurobond differ from similar German bonds by just 60–70 basis points.

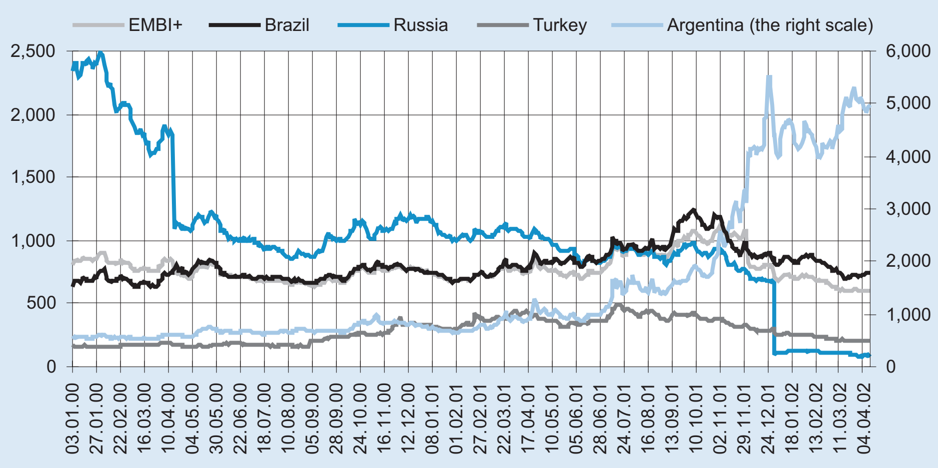

Figure 1. Emerging Markets Bond Index EMBI+ (www.jpmorganchase.com)

Argentina, but also Peru, Pakistan, Russia and the Ukraine stick out among other countries by having to declare themselves insolvent in the course of the financial crisis and default on servicing their debts. The current article focuses particularly on such a case – how to solve sovereign insolvency or, in other words, bankruptcy. The author tries to give an overview of the development of theoretical thought in this area as well as the international framework of sovereign debt restructuring that is being discussed.

How Has the Problem of Sovereign Debt Been Solved Before?

The need to resolve the problem of sovereign insolvency or bankruptcy has been known for more than a century. In 1874, the Corporation of Foreign Bondholders announced that it sees a need for international rules that would regulate the relations between a sovereign state and its foreign trade partners[1]:

[1] Krueger, A. O., Sovereign Debt Restructuring Mechanism: One Year Later, speech held on 12 November 2002. See http://www.imf.org/external/np/speeches/2002/111202.htm

During the autumn of last year, a conference of jurists and public men of various countries ... [discussed] ... the possibility of international agreements upon the principles of law which should determine the liability of sovereign states and foreign subjects in their relations to one another. ... There can be no question as to the advantage that would result from such an agreement.

In 2002, the IMF completed a survey on the early ideas on sovereign bankruptcy reorganisation[2]. The survey focuses on different possibilities that would help countries to overcome debt crises with minimum costs for both the debtor country and the creditors. Speedy and effective restructuring of the debt is the only way that keeps crisis-related costs as low as possible.

The survey analyses several periods. First, the years 1970–1981 when Christopher Oechsli suggested that the debt problems of developing countries could be solved under procedures of Chapter 11 of the US Bankruptcy Reform Act of 1978. Under Chapter 11, the first step in the bankruptcy of a private business is to restore its financial position to such a level that it would be possible to demand repayment of debt from the company and give it a chance to start a new. This is done by a set of rules under which the creditors and the debtor attempt to settle the issues related to the suspension of debt servicing. An important role belongs to the ability of the majority creditors to decide on the terms of restructuring, temporary suspension of repayments and protection of the interests of creditors.

Debt problems of developing countries could be solved under procedures of Chapter 11 of the US Bankruptcy Reform Act of 1978.

The debt crisis that hit developing countries in the early 1980s also put forward important ideas on international bankruptcy procedures in the style of Chapter 11. Jeffrey Sachs published an influential study titled *Theoretical Issues in International Borrowing,*[3] where he discussed the collective action problems associated with coordination like creditor panics, which are similar to situations when depositors run to withdraw their money from a bank they no longer trust. Such behaviour will at one point bring the bank down. The panic sale of state property by creditors who financed the country has the same effect on the financial situation of a country.

The continuation of the debt crisis throughout the 1980s led the US, whose banks had lent extensively to Latin American countries, to a brave plan, which was called the Brady Plan, after then Treasury Secretary Nicholas Brady. The essence of the plan was that the hope that developing countries would repay all their debts was unjustified. Thus, the developing countries were given an official chance to ask for debt reduction from private creditors and the USA asked the IMF to change its loan policy. Unlike the earlier approaches, the IMF had to first disburse loan instalments to countries that needed loans and not wait until the country had

[2] Rogoff, K., Zettelmeyer, J., Early Ideas on Sovereign Bankruptcy Reorganization: A Survey, WP/02/57.
[3] Sachs, J., Theoretical Issues in International Borrowing, Princeton Studies in International Finance No 54, July 1984.

met all its obligations to the private sector (commercial banks). The earlier IMF policy was the main instrument that forced developing countries to honour their debt commitments[4].

In 1989–1994 Benjamin Cohen proposed the adoption of the so-called global Chapter 11, accompanied by either changes in the IMF Articles of Agreement or the creation of an entirely new international organisation – the International Debt Restructuring Agency. Both ideas resemble the ideas suggested today. Already back then it was understood that the agency solving international debt problems could only have the authority of a bankruptcy administrator and all the decisions would be made by the majority creditors.

By the early 1990s, the debt crisis had been overcome and the developing countries further reduced their control over capital movement. Estonia has pursued a similar policy, facilitating the entry of foreign direct investments into the country to make more effective use of the local resources. Until the Mexican 1994–95 balance of payments crisis, there was no literature on sovereign bankruptcy procedures, but then the situation was reversed. The IMF granted Mexico the biggest crisis loan in the history of the Fund, which led to the frequently quoted speech by Jeffrey Sachs[5] in which he points to the legal shortcomings of the international financial sector related to international capital movement and the inefficiency of the crisis loans of the IMF (the so-called lender of last resort loans). As a solution, Sachs suggested that the IMF should be turned from a lender of last resort into an international bankruptcy court.

New Ideas on Restructuring Sovereign Debt

First Deputy Managing Director of the IMF Anne Krueger expressed some preliminary thoughts on the need to establish a sovereign debt restructuring mechanism (SDRM)[6]. By today, the proposal has received numerous responses from both creditors and potential debtor nations.

The idea under discussion is the following: sovereigns with unsustainable debt burden have no possibilities under the current international regulations to solve their debt problems in a simple and understandable way. Experience so far indicates that sovereign debt restructuring is time and capital consuming for both debtors and creditors. The new mechanism proposed by the IMF would work as a solution involving private sector creditors, ie, the debtor and (private sector) creditors would agree on debt restructuring and the proposed framework would prevent speculative creditors from blocking the solution by litigation. The new model would also exclude IMF loans to insolvent sovereigns.

How to restructure unsustainable sovereign debt so that it would not take long and some creditors would not be able to sue the state for suspending debt servicing? Developing countries can have very different creditors, from large commercial banks to private persons, and a host of different debt instruments – loans, bonds, trade credits, etc.

[4] Krugman, P. R., Obstfeld, M., International Economics. Theory and Policy, pp 704–705.
[5] Sachs, J., Do We Need An International Lender of Last Resort?, unpublished manuscript, 20 April 1995.
[6] See Krueger, A. O., International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, 26 November 2001.

Another problem concerns laws under which the loan has been issued. Namely, it has become customary that developing countries issue bonds under the laws of the developed country where the financial centre is located. This simplifies the sale of bonds to foreign investors. Thus, for example, the first Eurobonds of the Republic of Estonia were issued under English law in 2002. The laws of a particular financial centre (New York, London, Frankfurt, Tokyo, etc) give investors and debtors different rights. It is also important to know that the use of NY or English laws is most widespread. If the debtor suspends the servicing of bonds issued under the New York laws (the so-called Yankee bonds), creditors have no right to change the payment terms of the bond agreement. This means that if the debtor country suspends the servicing of such a loan or changes the terms of payment the creditor has the right to turn to the court. In case of a debt crisis, this increases pressure on the already meagre finances of a country and slows down the entire process of negotiations. English law allows changing all the clauses of a contract if the majority of creditors agree to that. As many countries have issued bonds under different laws, the restructuring of the entire sovereign debt can prove very time-consuming and painful.

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What could be the solution? The first possibility is that both parties understand that the problem is least painful to all parties when the solution is found promptly and according to internationally agreed rules, which makes the whole process predictable and reduces uncertainty. Although it is possible to rely partly on the rules of the domestic bankruptcy process, it is true that a country is, in principle, different from a company. Still, some good practices of the main areas of the bankruptcy process can be adopted and applied also to the restructuring of sovereign debt or the SDRM process. These practices include:

1) **the question of restructuring is decided by the majority.** This means that creditors get the right to vote for or against the restructuring and its terms. If a small part of creditors (minority) votes against, the decision adopted by the required majority is also binding for them and no creditor has the right to sue the sovereign for suspending debt servicing;
2) **all transactions with state assets are stayed for the period of solving the debt problems.** If creditors and the debtor do not find a solution to the payment problems before the staying, all payments made by the sovereign are temporarily stayed. The official but temporary suspension will last until the terms of debt restructuring are negotiated;
3) **the first priority is given to protecting the interests of creditors.** This means that the restructuring mechanism has to offer sufficient security and legal protection to creditors at the time when the servicing of sovereign debt is temporarily stayed. The creditors have to be sure that no deals reducing the value of state assets (ie collateral of the debt) are made which would further undermine the chances of creditors to get their money back;

4) **the status of a preferential creditor would, besides international organisations, apply also to those creditors who agree to grant additional loans to the sovereign after the emergence of problems;**
5) **the entire negotiation process is carried out by an arbitration agency.** The forum to settle disputes related to sovereign debt would consist of a board of experts approved by all IMF member countries. The board would register claims of creditors, check the legality of the claims and thus support seeking a prompt solution for restructuring. The authority of this forum would be limited to an administrative role.

Conclusion

Working out the framework of sovereign debt restructuring is thus a thorough and major undertaking at the IMF. The goal is to cut back the inefficiencies that have manifested itself on international markets, although it is far from easy to reach an international agreement that would satisfy all the parties and member countries of different level – it could take years. There are several examples of sovereign debt crises in recent history and the need for a uniform framework for sovereign debt restructuring has become more and more acute. Argentina has not been helped out of the 2001 debt-servicing crisis yet and the country's debt has not decreased but rather increased by interests. Of course, an international agreement on sovereign debt restructuring will not free sovereigns from their responsibility for excessive borrowing, but it might make the debtors as well as the creditors, who would have to bear direct costs, weigh the risks of borrowing and lending more thoroughly.