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International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring

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I. Introduction

Mr Chairman. Ladies and Gentlemen.

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It is a great pleasure to be here tonight. For more than 30 years the National Economists' Club has provided a valuable forum, bringing together economists from the public and private sectors, from universities and think-tanks, and from national and international bodies. Having just made the transition from academia to a Bretton Woods institution for the second time, I know how useful and stimulating it is to meet with - and learn from - fellow economic practitioners working in different fields. So thank you for inviting me to meet with you this evening.

My topic tonight has been of concern to economists and policymakers for a number of years. As you know, much has been done to strengthen the architecture of the international financial system in response to the recent emerging market financial crises. But there remains a gaping hole: we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors.

It is high time this hole was filled. This evening I would like to share with you an approach that the management and staff of the IMF are discussing and which we believe could be implemented.

Our aim would be to create a catalyst that will encourage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner. This catalyst would take the form of 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. The mere knowledge that such a framework was in place should encourage debtors and creditors to reach agreement of their own accord. Our model is one of a domestic bankruptcy court, but for a number of reasons it could not operate exactly like that. It is better to think of it as an international workout mechanism.

A number of our members have expressed a desire to move in this direction. We look forward to discussing our ideas with the Fund's Executive Board next month. But even with unanimous political support this approach could not be in place for at least two or three years. So none of what I have to say tonight has implications for our current negotiations with member countries - Argentina and Turkey, for example.

Let me begin by putting our proposal in the context of other changes made to the architecture of the international financial system. I will then talk about the current obstacles to orderly sovereign debt restructuring, before turning to the principles that underpin the possible new approach and some of the practical questions it raises.

II. Reforming the Architecture

Architecture first. The growth of private international capital flows has delivered important benefits for borrowers and providers of capital alike. Foreign direct investment has risen steadily in importance, but as portfolio flows have become larger and more volatile, a price has been paid in more frequent and more severe financial crises.

One response of countries afflicted by the crisis would have been for them to retreat from the global capital markets, but almost without exception even those suffering most in the turmoil have chosen not to do so. Instead, they have rebuilt investor confidence and helped restore growth by putting in place corrective policies: fiscal adjustment, financial sector strengthening, and more flexible exchange rate regimes, to name but three.

In addition, as the smoke has cleared, the international community has made a determined effort to promote more effective crisis prevention. This has had three main elements:

First, we have strengthened the IMF's surveillance of national economic policies, and international markets. Second, we are encouraging better communication between the IMF, its members, and private investors and lenders. And third, we have created the Contingent Credit Line facility, offering countries with sound policies a public "seal of approval" and a way to bolster their official reserves at very low cost.

Better national policies and the reforms made to the architecture should help make crises less frequent. But prevention will never be foolproof. So we have also taken steps to improve the management of crises. We have been guided by the recognition that capital account crises - in which countries face exceptional balance of payments problems because of a sudden loss of investor confidence - require solutions different from the current account problems that the Fund has traditionally had to deal with.

One important advance in crisis management has been a change in the content of the adjustment and reform programs that the Fund supports in helping countries recover. In addition to the necessary macroeconomic

prescriptions, we focus much more urgently on helping to resolve balance sheet problems in the financial and corporate sectors. In many cases these problems were at the heart of the 1990s crises.

Another advance was the creation of the Supplemental Reserve Facility in 1997. This moved the Fund in the direction of Walter Bagehot's classic prescription for a lender of last resort, advancing large amounts for relatively short periods at penalty interest rates. In lieu of collateral, Fund lending requires agreement with the borrower on economic policy measures that will improve its balance of payments and help it repay.

But the parallel between the Fund and Bagehot's lender of last resort cannot be taken too far. For one thing, unlike a domestic central bank, the Fund cannot print money. Its resources are limited to part of the quotas paid in by its members and the borrowing agreements it has in place with a number of industrial and emerging market countries. In an informal but nonetheless important way its lending is also limited by the understandable reluctance of Fund members to see resources used to bail out private creditors of countries that find themselves in trouble. Moral hazard remains a concern. Private institutions may be encouraged to lend and invest recklessly - or at least more than they should - by the belief that the Fund will ensure that their creditors can repay them.

III. Involving the Private Sector in Crisis Resolution

Let me now turn to the question of involving the private sector in crisis resolution, which is certainly among the most difficult issues in reforming the architecture of the international financial system.

Temporary assistance from the Fund and agreement on a convincing economic adjustment package is normally sufficient to rebuild confidence among investors and lenders - and restore a country's access to foreign private capital. But what if banks and bondholders suddenly take fright and want to pull out of an emerging market? Or if a country faces a short-term need for foreign currency beyond that which the official sector is willing and able to provide, and has little prospect of securing private capital in the near term? Then it may be necessary to encourage private creditors to roll over existing commitments and to limit their demands for repayment. This is what is meant by concerted involvement of the private sector in crisis resolution. When a country has a large debt, it is not just the flows we have to worry about, but what happens to the stock. When creditors will not roll over the stock, there is still a problem.

In the 1980s, restructuring sovereign debt was a protracted but generally orderly process. Typically the major creditors were commercial banks, and they negotiated through a steering committee of maybe 15 people holding perhaps 85 percent of the debt. They had a number of incentives to cooperate. First, they wanted to maintain good relations with the debtor to safeguard future business. Second, they were subject to the suasion of the official sector through regulators, especially since they were banks. Third, conflicts between creditors were limited by similar financial and institutional interests. And fourth, there was little incentive

for holdout creditors to pursue claims through litigation, because they would have had to share any proceeds with fellow creditors.

Today we live in an entirely different world. Since 1980 emerging market bond issues have grown four times as quickly as syndicated bank loans. With many banks and bondholders now involved, private creditors have become increasingly numerous, anonymous, and difficult to coordinate. The variety of debt instruments and derivatives in use has also added to the complexity with which we must deal.

Bondholders are more diverse than banks, and so too are the goals with which they approach a restructuring. Some are interested in a rapid and orderly restructuring that will preserve the value of their claims. Others, which buy debt on the secondary market in hope of profiting through litigation, prefer a disorderly process allowing them to buy distressed debt more cheaply. Individual bondholders also have more legal leverage than banks and are less vulnerable to arm-twisting by regulators.

No wonder countries facing severe liquidity problems often go to extraordinary lengths to avoid restructuring their debts to foreign and domestic private creditors. Even an orderly restructuring can impose severe economic costs and devastate the domestic financial system; a disorderly restructuring can block a country's access to private capital for years to come, making an already bad situation even worse.

But when a country's debt burden is truly unsustainable, the inevitable cannot be put off forever. In Pakistan, Ukraine and Ecuador fears that litigation would disrupt the process in fact turned out to be unduly pessimistic. But the more recent success of an aggressive legal strategy employed against Peru by a vulture company called Elliott Associates underlines the power that holdout creditors retain. The threat of disruption remains likely to deter countries from seeking a necessary restructuring for longer than is desirable either for the country itself or for the international community.

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

It is not clear if Elliott's strategy would survive legal challenge in future cases. But this case - and the possibility that rogue creditors will open other legal avenues - shines a spotlight on what is a missing element in the international community's current approach to the roles of the public and private sectors in debt restructuring.

The current approach to private sector involvement was endorsed by our members last year. Noting that official financing is limited and that creditors and debtors need to take responsibility for their decisions, it

favors voluntary and market-oriented solutions to debt problems wherever possible. In most cases policy adjustment and temporary official financing is assumed to be sufficient to restore a country's access to private capital. In some cases, the official sector will also need to encourage creditors to reach voluntary agreements to help overcome their coordination problems. And when there is no realistic chance of restoring access to private capital on terms that will leave its debt burden sustainable, a more comprehensive restructuring may be required within the context of a Fund-supported adjustment program.

Ideally, this should be achieved in a largely voluntary and market-friendly way. But Peru's experience suggests this may be more difficult to achieve in the future. Our members agreed that in these circumstances the Fund should be prepared to give its implicit support to a temporary standstill in a country's debt repayments, as long as it is implementing a sensible economic adjustment package and is ready to negotiate with its creditors in good faith. The Fund would signal its support by being prepared to lend to the country even though it was in arrears to its private creditors.

But implicit support of this kind would not prevent holdout creditors from disrupting the restructuring. As a result, the current approach does not provide an adequate incentive for debtors and creditors to reach agreement of their own accord.

This is the missing element we must provide. Let me explain now in broad outline how we could do it.

IV. A New Approach to Sovereign Debt Restructuring

A formal mechanism for sovereign debt restructuring would allow a country to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling or restructuring with its creditors, given the Fund's consent to that line of attack. During this limited period, probably some months in duration, the country would have to provide assurances to its creditors that money was not fleeing the country, which would presumably mean the imposition of exchange controls for a temporary period of time.

As I have emphasized already, our primary objective in creating a formal mechanism of this type would be to create incentives for debtors and creditors to reach agreement of their own accord, so the mechanism would rarely need to be used. There is an analogy here with domestic insolvency regimes like the US bankruptcy court. When they are well-developed and predictable in their operation, the bulk of domestic corporate restructuring takes place "in the shadow of the law" rather than in court.

This approach would benefit creditors as well as debtors. The threat of disorderly restructuring means that when countries get into trouble, the value of their debt on the secondary market falls much more sharply than it would do in a more predictable environment, imposing losses on investors and lenders who mark to market. By helping resolve collective

action problems among the creditors, it will help protect the value of their claims.

It is also worth emphasizing that while this proposal would create a mandatory *process* for restructuring, the outcome in any given case will remain where it should be - in the hands of the debtor and creditors. Holdout creditors would be restrained in the event of an agreement, but it would remain for the bulk of the creditors to negotiate and ultimately decide whether to accept the terms on offer. The international community is not going to impose the terms of any restructuring agreement on debtors and creditors.

The new approach would also benefit the international community more widely, by contributing to a more stable international financial system. The presence of a formal mechanism that would encourage them to restructure would help convince private institutions that the official sector is not waiting on the sidelines to bail them out when things go wrong. This could reduce the overall volume of capital flowing into the emerging markets. But that would be no bad thing if it meant that creditors and debtors were assessing risk more appropriately. Sound lending and borrowing decisions would in turn make it less likely that countries would find themselves overindebted to begin with.

A formal sovereign debt restructuring mechanism would need to be built on four key features:

- First, the mechanism would need to prevent creditors from disrupting negotiations leading to a restructuring agreement by seeking repayment through national courts. This would make restructuring less costly for the debtor country, reducing the incentive for it to try to delay the inevitable unnecessarily. It would also prevent a "grab race" getting under way among the creditors, in which each has an incentive to enforce its claim as quickly as possible to prevent others capturing the limited assets available.
- Second, the mechanism would have to provide creditors with some guarantee that the debtor country would act responsibly during the course of any standstill. In other words, that it was adopting appropriate economic policies, negotiating in good faith with its creditors, and refraining from treating some creditors more favorably than others.
- Third, private lenders would need encouragement to provide fresh money to help the debtor meet its financing needs. To achieve this, providers of new money might have some guarantee that they would be repaid before existing private creditors i.e. possibly some kind of preferred creditor status.
- Fourth, the mechanism would have to bind minority creditors to a restructuring agreement once it has been agreed to by a large enough majority. This would prevent rogue creditors demanding repayment on the original terms and achieving leverage by

securing an attachment on the assets of the debtor until they were repaid.

These four principles are much more easily stated than satisfied. They raise a number of practical questions for the operation of such a approach, with which we have been grappling and which are by no means settled upon. Let me discuss six of them briefly.

First, on what legal basis would such a mechanism rest? If we are to restrict the ability of creditors to enforce their claims in national courts, then the mechanism must have the force of law in those countries where enforcement might be sought. It would not be enough to pass laws in a few leading countries. In practice, the mechanism must have the force of law universally. Otherwise creditors will deliberately seek out the jurisdictions in which they have the best chance of enforcing their claims.

Second, who should operate the mechanism? The Fund's involvement would be essential to the success of such a system. We are the most effective channel through which the international community can reach a judgment on the sustainability of a country's debt and of its economic policies, and whether it is doing what is necessary to get its balance of payments back into shape and to avoid future debt problems.

Having said this, there are other parts of the mechanism to which the Fund's existing institutional structure would be less suited. For example, there will no doubt be a need occasionally to adjudicate disputes among creditors and between the creditors and the debtor. It will also be necessary to verify creditor claims and confirm the integrity of voting on a potential restructuring. These are not things the Fund could well do.

Third, what would determine if and when the mechanism was formally set in motion? The standstill would be activated if a request by the debtor country was endorsed by the Fund. The Fund would agree if in light of the limitations on the official finance available, the member's debt profile was unsustainable and it had little prospect of securing access to private capital in the foreseeable future.

The presence of a predictable framework should encourage the debtor and creditors to get together of their own accord, mimicking the features of the formal process as happens frequently in domestic bankruptcy regimes. But even if there is broadly-based agreement on a restructuring, activation of a formal standstill may still be necessary in order to bind potential holdout creditors into the majority decision.

Fourth, how would we ensure the debtor behaved appropriately while it was enjoying protection from its creditors? There is a clear analogy here with the way the Fund ensures that countries get their policies back on track when it is lending to them. Like an IMF-supported adjustment program, the standstill could be endorsed for limited periods and renewed following reviews of the country's economic policies and its relations with its creditors. Establishing a maximum period beyond which the stay could not be maintained without the approval of a

required majority of creditors would also encourage the debtor to negotiate in good faith.

Fifth, what financing should the Fund provide? After the restructuring, Fund financing should be limited to the amount necessary to help rebuild reserves and pay for essential services and imports. There should be no extra support to help finance payments to creditors on the restructured debt.

Sixth, what types of debt should the stay and the binding-in of minority creditors apply to? This involves a number of complex issues. Let me mention two: the treatment of sovereign debt owed to domestic residents and the treatment of foreign debts owed by domestic residents other than the sovereign.

Sovereign debt owed to domestic residents may well need to be included in any restructuring for three reasons. First, in the absence of capital controls, balance of payments problems are as likely to arise from the flight of domestic investors and lenders as from withdrawal of foreign ones. Second, domestic debt may impose an unsustainable fiscal burden, especially as the crisis will already be weakening the country's budgetary position by depressing economic activity. Third, external creditors are less likely to agree to a reduction in the value of their own claims if they know that domestic investors are simultaneously being repaid in full or in much greater proportion.

The stay might also need to apply to foreign debts owed by nonsovereign residents. This is because of problems created by the use of exchange controls to protect foreign exchange reserves. A company that is relatively unaffected by the crisis, perhaps because most of its earnings come from exports, may suddenly find itself vulnerable to litigation because exchange controls might prevent it paying its overseas creditors during the period of the stay. An alternative would be to extend the legal protection offered to the sovereign to these enterprises as long as they make the payments they would have made to their creditors into an escrow account. These could then be paid to the overseas creditors once the exchange controls are lifted at the point at which the stay is terminated.

V. Conclusion

Let me conclude by discussing briefly how the approach I have outlined would affect the incentives faced by the key players in the sovereign debt market.

For debtor countries, the new approach would clearly reduce the cost of restructuring and would encourage countries to go down that road earlier than they do now. This is no bad thing. At the moment too many countries with insurmountable debt problems wait too long, imposing unnecessarily heavy economic costs on themselves, and on the international community that has to help pick up the pieces.

But it would be ridiculous to argue that our approach would make

restructuring an easy option. I would not support it if it did - countries, like anyone else, should pay their debts as long as they are able to do so. Under the new approach, as now, even an orderly restructuring can impose severe economic costs and threaten to devastate the debtor's banking system if it holds a lot of sovereign debt. No country is likely to go down this path unless it absolutely has to.

For creditors, our new approach might appear unattractive if it meant that debt problems were more likely to be dealt with through restructuring than through large bailouts from the official sector. But most creditors now accept that official financing is limited and that the choice is not between workout and bailout, but between an orderly restructuring and a disorderly one. For most creditors the guarantee of an orderly restructuring is much to be preferred to the threat of a disorderly one. The value of their claims on the secondary market is unlikely to fall anywhere near as much as it does now when a country starts to get into trouble.

The approach I have outlined tonight holds out the promise of a fairer and more efficient process of sovereign debt restructuring, one which would encourage countries to resolve unsustainable debts promptly and in an orderly fashion. There are many technical questions to be addressed and we look forward to discussing them with our executive board, which is the next step. But some approach along these lines would serve the causes of better crisis prevention and better crisis management simultaneously, to the benefit of debtors, creditors and the international community.

The political imponderable is whether our members are prepared to constrain the ability of their citizens to pursue foreign governments through their national courts as an investment in a more stable - and therefore more prosperous - world economy. This, ultimately, is a matter for them.

I for one hope that they are - and I know that in time they will have to. I hope they will sometime soon. Thank you.

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