The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode

by

Nouriel Roubini
Stern School of Business
New York University

and

Brad Setser
Council on Foreign Relations

This draft: April 2004

Abstract

The paper overviews the recent debate on the how to reform the sovereign debt restructuring process to make it more orderly. It discusses the market failures in such restructurings and the proposed solutions. These include a sovereign bankruptcy regime, the introduction of collective action clauses in debt contracts and a code of conduct. The current emphasis on the contractual approach is appropriate. But clauses will not resolve all the problems in debt restructurings. Legal reform and litigation are not the central issues that delayed the Argentine restructuring. Thus, the reform agenda should be broadened to ensure that debt crises and restructurings become more orderly.

Keywords: sovereign default, debt restructuring, crisis resolution, Argentina

Nouriel Roubini: nroubini@stern.nyu.edu; Brad Setser: brad_setser@msn.com

A previous version of this paper was originally prepared for the conference on "Improving the Sovereign Debt Restructuring Process" co-hosted by the Institute for International Economics and Institut Francais des Relations Internationales, Paris, March 9, 2003. We thank Fred Bergsten, Ted Truman, Bill Cline, Anna Gelpern, and Jean Pisani-Ferry for useful comments and suggestions on that draft. The usual disclaimer applies with force: the opinions expressed in this paper are strictly those of the authors and not of any other institution or organization.

Introduction

The IMF's proposal for a new statutory sovereign debt restructuring mechanism – in conjunction with Argentina's default on its international bonds – have forced the international financial community to consider whether it is worthwhile to try to make major changes to the existing sovereign debt restructuring process. The outcome of this debate, at least to date, looks likely to be incremental reforms, not radical change. By early 2003, if not before, it was clear that there was not a consensus in favor of a treaty creating a new international bankruptcy regime for sovereign borrowers. Instead, an old idea -- the introduction of collective action clauses into new sovereign bond contracts to limit the legal risks posed by holdouts – has been embraced with new vigor.

The expanded use of collective action clauses will result in some tangible improvements in the sovereign debt restructuring process. But there also are limitations to what clauses – or for that matter the statutory regime outlined in the IMF's final proposal - will achieve. Legal reform was never a precondition for successful sovereign debt restructurings: Pakistan, Ukraine, Ecuador, Russia and Uruguay have been able in recent years to restructure their international sovereign debt without the help of an international bankruptcy regime, and several were able to restructure bonds that lacked collective action clauses. Legal reform – at least legal reform that focuses on making it easier to force a minority to accept a restructuring proposal acceptable to a majority of creditors - is unlikely to transform radically the incentives facing either sovereign debtors or the official sector. The legal ability to bind in a minority alone will not significantly lessen the real economic costs of defaults or make it easy to turn down a country' request for official support. Proponents and opponents of clauses and the IMF's bankruptcy regime alike have tended to overstate the impact of legal reform on the sovereign debt restructuring process.

Clauses will make the existing process for sovereign debt restructuring work better at the margins, but they will not create a fundamentally different process. Indeed, the clearest lesson that has emerged for Argentina's debt restructuring is that too much energy has been invested in the debate over changing the legal documentation in sovereign debt, and too little energy has been invested in thinking through the broader role the IMF should play in a debt restructuring. Clauses can help to coordinate the restructuring of a single bond. But a restructuring as complex as Argentina's requires changing the terms of 90 international bonds, as well as restructuring a whole host of domestic debts. Bond clauses do not provide a framework that can help to coordinate such a restructuring. Nor can they help coordinate the country's own macroeconomic policy adjustments with the debt restructuring. An IMF program can serve these functions. If the IMF is either unable or unwilling to use its financial leverage to produce an agreed macroeconomic framework, the likely outcome is delay no matter what the legal framework.

This paper is organized as follows: the first section discusses the problems that arise when a sovereign needs to restructure its debts; the second section discusses the five broad approaches toward reform that emerged during the recent debate on reforming the debt restructuring process; the third section looks at the impact the broader introduction of collective action clauses will have on the sovereign debt restructuring process; the fourth section looks at Argentina's recent default; and a fifth section lays out our recommendations for improving the sovereign debt restructuring process.

I. Problems that arise in a sovereign debt restructuring

Everyone – or at least almost everyone – can agree on the general need to improve the sovereign debt restructuring process. But agreement on the need for improvement masks different conceptions of the fundamental problems in the current sovereign debt restructuring process. The official sector looks at the sovereign debt restructuring process and sees a process that is too "disorderly," too open to disruption by litigation and too costly to the debtor. Private creditors see a process where there is no agreement – or rules – that outline how different creditor groups will be treated, and hence see a constant risk that a sovereign's external bondholders will be treated less well than other creditor groups. They also see a process where – official sector complaints about litigation to the contrary –creditors have far fewer legal rights than creditors of a bankrupt firm. Sovereign debtors see yet another set of problems. While capital flows to emerging economies picked up in 2003 on the back of exceptionally low interest rates in the world's major economies, emerging debtors know better than most that capital flows to emerging markets remain well below the halcyon days of the mid-1990s. They worry at least as much about the risk that the introduction of new legal protections would shrink the size of the market for international sovereign debt as they worry that their existing debt contracts will make it too easy for a holdout to disrupt a restructuring.

Rather than detailing all of the specific complaints that have been made, it makes more sense to step back and consider some of the basic problems (market failures and/or externalities) that arise in a debt restructuring. [1] These include:

A rush to exit from the sovereign's own debt. Creditors have good reason not to roll over claims on a sovereign that they believe will need to seek a restructuring in the near future. Indeed, creditors have an incentive – given all the inherent uncertainties associated with any debt restructuring process – not to roll over claims on an "illiquid" but still "solvent" sovereign. The maturity structure of the sovereign's debt tells creditors rather precisely where they stand in the queue of get out. Those with debt coming due in the near term are in the front of the queue, and may be able to get out before the sovereign runs out of either international reserves or decides to stop paying. Those holding long maturity claims are stuck: they can sell their claim to another creditor, probably at a discount, but that just transfers the claim to another creditor. The Bank of Canada and Bank of England, among others, have noted that there is a simple solution to a run on a sovereign: suspend payments on the sovereign's debt (or at least the sovereign's external debt) and then renegotiate the debt's terms. This, however, gives rise to other sorts of problems.

A rush to the courthouse. Suspending payments stops the rush to the exits, but a unilateral payments' suspension leaves the debtor open to risk of litigation. In practice, though, a "creditor grab race" to seize a sovereign's assets after default has not proven to be much of a problem. A bankrupt sovereign typically does not have many international assets to begin with, and the sovereign's international reserves and diplomatic property already enjoy considerable legal protection. Creditors can litigate to make it difficult for a sovereign to "selectively default" on its external commercial debt, but cannot do much more. External creditors have neither the ability to lay claim on the sovereign's domestic

[1] See Roubini (2003) and Roubini and Setser (2004) for more details.

assets nor the ability to go to court and force the sovereign to spend less and tax more to be able to pay more on its external debt.

Free riders or holdouts. All creditors would be better off if they all agreed to restructuring that put the debtor back on a sustainable path, but each creditor individually would be better off if it held out while other creditors agreed to restructure, and then litigated to get paid in full. Of course, if too many creditors try to hold out, it does not make sense for the sovereign go through with a restructuring. The sovereign will stay in default, to the detriment of all its creditors. But if the number of creditors holding out is manageable (or if the legal risk posed by holdouts is judged to be low), the sovereign may opt to go ahead with the restructuring despite some holdouts. These holdouts can then seek to convince a court that the sovereign should not be allowed to pay its new debt so long as it is not fully honoring its old contractual commitment. But this is a risky strategy. The most successful example of holdout litigation (Elliot's litigation against Peru) hinged on an interpretation of a key clause -- the pari passu clause -- that may, or may not, survive further court tests.

The absence of an enforceable priority structure for the sovereign's own debt that helps to settle questions of equity and the relative treatment of different creditor groups. A bankruptcy regime typically does more than let a firm that reaches agreement on restructuring terms with a super-majority of its creditors that makes those terms binding on all creditors, eliminating the holdout problem. It also lets creditors know ex ante how they will be treated in relation to other creditors holding similar types of claims. In other words, it sets out rules of priority that define where creditors stand in the pecking order. Some informal rules of priority are generally followed in a sovereign debt restructuring: for example, it is hard for a sovereign to treat one bond issue substantially better than another bond issue, and the IFIs (the IMF, the World Bank, and the regional development banks) are de facto given priority relative to other external claims. But there are no rules that determine how a sovereign should treat their unsecured domestic debt vis-a-vis their unsecured external debt, and the existing framework for coordinating the restructuring of external bonds and external debt owed to other governments is under considerable strain.

Policy conditionality. There is an obvious need to coordinate the steps that creditors agree to take to make it easier for the debtor to pay with the steps that the debtor agrees to take to increase its ability to pay. This too poses challenges of collective action – after all, creditors are unlikely to have the exact same conception of what steps the debtor should take. The current system for sovereign debt restructuring attempts to address this problem largely by linking the debtor's program of policy reforms to new money (or the refinancing of existing exposure) from the IMF rather than by direct negotiation between the debtor and its external private creditors.

Rush to default. Legal changes that make restructuring too easy risks making default too likely, and therefore making credit for the sovereign too scarce. The risk that legal change will reduce a sovereign's incentive to make the effort needed to pay its debts has to be balanced against the gains from making it easier for a debtor that finds itself in a position where it cannot pay to reach agreement with its creditors on a restructuring that allows it to resume payments.

Other runs. Stopping payments on the sovereign's own debt eliminates a direct source of pressure on the sovereign's reserves. But it may trigger other runs, a run on the domestic banking system, a run on the currency and a withdrawal of cross-border bank credit. Domestic residents may seek to trade domestic bank deposits and other local financial assets for foreign bank accounts and foreign financial assets. However, if everyone wants out, in many cases, no one can get out. Prices go into free fall, reserves are exhausted, banks cannot meet their commitments to return deposits on demand and both bank deposits and currency markets end up frozen, at least temporarily.

Despite the similarities between corporate bankruptcy and sovereign debt restructuring, any analogy between a sovereign and a firm also has its limits. The absence of a formal sovereign bankruptcy regime that provides bankrupt sovereigns the same protection as bankrupt firms is not necessarily evidence of a gap in the international financial system. Sovereigns already informally enjoy many of the protections that a firm can only obtain through a formal bankruptcy regime simply by virtue of the difficulty taking effective legal action against a sovereign. Moreover, the informal priority given to the IMF allows it to provide a sovereign with new money (such financing for firms is provided with formal priority) and an IMF program also acts as a substitute (creditors might argue an imperfect substitute) for court supervision of the debtor while the debtor is negotiating new payment terms with its creditors. At the same time, there is little doubt that the absence of a formal bankruptcy process does create certain complications: for example, a sovereign that reaches agreement with a large majority of its creditors still needs to worry about a few holdouts, while a firm does not.

II. Proposals for reform

No single proposal realistically could be expected to provide a comprehensive solution to the full range of problems that arise in a sovereign debt restructuring. Solving some problems may make other problems worse – offering the debtor too much protection after default could dilute the debtor's incentives to reach an agreement to resume payment, if not the debtor's incentives to take policy steps to avoid default. There are problems, like the holdout problem, that lend themselves to a legal solution, and problems which are unlikely to be ameliorated by legal change. Domestic bank depositors do not run just because a sovereign currently lacks formal bankruptcy protection.

Three general proposals have been put forward to solve some of the problems that arise in a sovereign debt restructuring: the introduction of new contractual provisions into new external debt contracts (or collective action clauses, CACs); the development of a code of conduct for a sovereign (and perhaps also its creditors) to follow during a debt restructuring; and the creation of a new statutory regime to provide bankruptcy-style protection for a sovereign. There are different variants within each option – both creditors and the official sector have put forward "contractual" proposals, and the IMF's proposal for a statutory sovereign debt restructuring mechanism (the Sovereign Debt Restructuring Mechanism, or SDRM in acronymese) evolved over time. The debate is not just clauses versus a statutory SDRM versus a code. It is also over what kind of clauses, what kind of SDRM and what kind of code. These are not mutually exclusive options. A code of conduct could be combined with contractual change, or embedded in a statutory regime. But there are some combinations that make more sense than others. Five broad options emerged out of the recent debate.

1. *Live with the status quo.* There is an existing debt restructuring process. It has its flaws, but at the end of the day, the current system allowed Ecuador and Uruguay to

restructure their New York law bonds, Ukraine to restructure its English and German law bonds, Pakistan to restructure its English law bonds, and Russia to restructure over $28 billion in "London Club" loans into $21 billion of new Eurobonds. Most sovereign bonds are governed by either English or New York law. While traditional English law contract allows a supermajority of bond holders to amend the bond's financial terms, a traditional New York law contract requires the *unanimous* consent of all creditors to change the bond's "key financial terms." However, a traditional New York law bond contract also defined key financial terms narrowly, as payment dates and amounts, and allowed all other terms to be altered with the support of one-half or two-thirds of the outstanding bondholders. This provided the debtor with a powerful tool to encourage participation in a bond exchange. In the near term, all contractual proposals will result in a restructuring process that is far closer to the existing process than to any idealized model: the existing $200 billion plus stock of external law sovereign bonds is a constraint on the ability to any contractual proposal to change the restructuring process.

2. *Expand the use of majority restructuring clauses and adopt a non-binding code.* The introduction of provisions in New York law bonds (and German law bonds) that allow a majority of bond holders to bind in a minority would gradually change the contractual terms in the existing debt stock. Proposals for the broader use of majority voting typically draw heavily on the documentation used in English law bonds and adopt the English convention of allowing a supermajority of bondholders (typically 75%) to amend all the bond's terms, including the bond's payment dates and amounts. The introduction of majority voting would, over time, reduce the risks associated with holdout litigation and hopefully make it somewhat easier for debtor to reach rapid agreement on restructuring terms with its creditors. Such clauses could be supported by a code that clarifies the existing debt restructuring process without imposing major new constraints on the debtor.

3. *The Group of Six's clauses and the IIF's code*. Contractual changes could limit the debtor's ability to amend non-financial terms, set high thresholds for amending financial terms, and force the debtor to pay for the expenses of creditors' committees. For example, the clauses suggested by the Group of Six creditor groups would introduce provisions for amending financial terms that are tighter than the provisions now found in English law bonds, and provisions for amending non-financial terms that are tighter than the provisions now found in New York law bonds.[2] A parallel code of conduct could set out major new requirements that a debtor would need to meet to gain access to IMF financing. These changes would give external private creditors increased leverage over a sovereign debtor, and make it harder for a debtor to use a bond's amendment provisions to drive creditors into a deal.

4. *SDRM-lite.* A "light" statutory regime could generate a restructuring process that closely resembles the restructuring process found in existing English law clauses, but with aggregated voting.   Aggregated voting would allow a single vote of all participating bondholders to determine the success of debtor's restructuring proposal. Since it is a lot harder to buy up a blocking position in the debtor's entire debt stock than to buy a blocking position in a single bond issue, this would effectively eliminate the holdout

[2] Several groups representing private creditors proposed allowing 85% of bondholders to amend a bond's financial terms, so long as no more than 10% of the bondholders object. That means it effectively takes 90% of bondholders to overcome the opposition of 10%.

problem. In addition to voting on the debtor's final restructuring proposal, creditors could vote whether or not to provide the debtor with interim legal protection. A treaty creating a statutory regime also would eliminate the need to wait until the existing stock of New York law and German law bonds is retired: the voting process created by the treaty immediately supersedes existing contractual provisions.

5. *SDRM-heavy*. A statutory regime could create a restructuring process that differs radically from the process that exists now. An ambitious statutory regime could change the existing restructuring process in various ways. It could empower the IMF to grant a debtor protection from litigation, and condition IMF sanctioned legal protection on an extensive set of policy guidelines. It could try to draw in a wide range of different debts – including domestic debt and Paris Club debt -- into a single negotiating framework. It could try to give new money formal priority over existing claims. A regime that combined all these features would resemble a Chapter 11 restructuring under U.S. bankruptcy law more than the current sovereign debt restructuring process.

III. Current Consensus: CACs are in, SDRM is out.

The IMF's proposal to create a statutory approach initially had the support of the U.S. Treasury – or perhaps more accurately, the support of Treasury Secretary O'Neill. But O'Neill never brought the rest of the U.S. government along with him. Only a few months after the IMF started its work on a statutory regime, the U.S. started to backpedal. The IMF did not give up easily. It modified its initial SDRM proposal three times. But it never found the magic formula. The joint opposition of the U.S., major emerging market economies and private creditors' representatives effectively doomed its proposal and formally stopped the IMF from pushing it in the spring of 2003.

The decision to stop working on the SDRM, though, was made much easier by the fact that first Mexico and then a series of other emerging market economies had started to introduce collective action clauses in their New York law bonds. Mexico had had a long tradition of setting important precedents for the emerging market debt market. Its decision in early 2003 to include provisions allowing amendment of the financial terms of its New York law seems to have set the new market standard. Prior to Mexico's decision, those emerging markets that typically issued bonds governed by New York law were reluctant to change their New York documentation or to shift their dollar issuance to London – presumably because of fears that any change would be perceived as signaling a reduced commitment to pay. However, the absence of a negative market reaction to Mexico's decision to start using English style majority voting provisions in its New York law bonds broke down barriers to innovation.

Mexico's bonds allowed 75% of the holders of the bond to amend its financial terms. Most emerging markets followed Mexico's lead. While Brazil initially included provisions that required the support of 85% of bondholders to amend the bond's financial terms, it recently has announced it will lower the threshold to 75%. Argentina has signaled that it will include majority restructuring provisions in the bonds that emerge from its debt restructuring. There now seems to be little doubt that Mexican style clauses are the new market standard. Some countries have even gone further: Uruguay included truly innovative aggregation clauses in the new bonds it issued as part of its debt exchange.[3]

The use of clauses certainly has not destroyed the sovereign bond market. The market value of emerging market bonds soared in 2003, spreads fell across the board and the new issuance market picked up after several years in the doldrums. This was not a surprise to those who studied this issue carefully. Investors – including the U.S. investors most opposed to English-style clauses -- all held bonds with collective action clauses in their portfolio long before Mexico put clauses into New York law bonds. Survey after survey indicated that investors were overweight Russia's dollar denominated bonds. Since Russia traditionally has used English law for its dollar-denominated bonds, investors were effectively overweight in bonds with clauses.

Standard clauses only address one of many coordination problems that arise in a sovereign debt restructuring. Mexico style-clauses only help coordinate the restructuring of a single bond issue by limiting the risk that a minority of holders of a single bond will not be able to block a the restructuring of that bond's terms that is acceptable to the majority of the other holders of that bond. A number of other coordination problems remain: coordinating the restructuring of different bond issues – something that is now typically done by an exchange offer; coordinating the restructuring of external bonds with other types of sovereign external debt (the Paris Club's "comparability requirement" is one example of mechanisms to deal with this kind of coordination); coordinating the external debt restructuring with the domestic debt restructuring – and in some cases, with the issuance of new bonds to recapitalize a collapsed banking system; coordinating the debt restructuring with the changes in the debtor's economic policies. All these coordination problems, more than litigation threats and holdout problems, were at the core of the difficulties in restructuring Argentina's sovereign debt after its 2001 default.

IV. Argentina's sovereign debt restructuring

The number of Argentina's outstanding instruments, the diversity of its creditor base (particularly the large number of retail investors), the legal complexity of its external debt stock and the importance of both its large stock of both domestic and external debt to its future sustainability all assure that Argentina's restructuring give rise to almost every problem that could arise in a sovereign debt restructuring. Ecuador did an exchange for six different bonds, Ukraine for five. Argentina has more than 90 different instruments outstanding. If Argentina were to demonstrate clearly that the current regime cannot be made to work in complex restructurings, issuers and investors alike may reassess their opposition to an ambitious statutory regime.

Argentina, though, is not simply a test of the current system's ability to handle a particularly complex restructuring. Argentina has also become a test case for a vastly reduced role for the IMF and the official sector more broadly in the sovereign debt restructuring process. In most recent debt restructurings - Pakistan, Ukraine, Ecuador,

[3] Uruguay's new bonds contain "aggregation" provisions that allow, at the discretion of the issuer, the votes of the different bonds issued as part of Uruguay's exchange to be pooled. In the aggregated voting process, the pooled votes of 85% of the outstanding principal of all relevant bonds is binding on the holders of each bond, so long as at least 67% of the holders of each individual bond issue also support the restructuring. In effect, the aggregation clause lowers the threshold for the amendment of an individual bond if a high proportion of the holders of all bonds that are part of the "aggregated" restructuring support the proposed amendment.

Uruguay - the IMF and the G7 played an active and engaged role in the restructuring process. The defaulting or near-defaulting country entered into negotiations with the IMF that provided a medium term macroeconomic policy program. This program included targets for primary balances and fiscal deficits, assumptions about likely developments in crucial macroeconomic variables such as growth, inflation, nominal and real exchange rates as well as structural reforms commitments. The IMF did not officially determine the exact amount of NPV reduction needed from private creditors to make the debt path sustainable over time, but the macroeconomic assumptions in the country's IMF program defined the core parameters for a restructuring that would, at least in principle, set the country on a path toward medium term sustainability.

One of the core reasons why countries traditionally negotiate a medium term economic program with the IMF rather than with creditors is that the IMF is better positioned to assess what a feasible adjustment path might look like than a group of uncoordinated creditors. A single entity like the IMF can reach agreement with the debtor more easily than a group of creditors with different and at times competing interests, and also it far better positioned to link its financing to monitored policy commitments. Even in the 1980s, creditors did not set the parameters of a sovereign debtor's economic recovery program; that was the job of the IMF.

Argentina is also shaping up to be different from recent bond restructurings in a second way. Countries typically have not engaged in extensive formal negotiation with their creditors on the terms of a restructuring deal. Instead, countries have hired financial and legal advisors that have sounded out the market to help the debtor assess the terms that a significant fraction of investors would accept. The country and its advisors would then launch a "take it or leave exchange offer" requiring a minimum participation rate (usually at least 80 or 85% of claims) for successful closure. In no case did the debtor negotiate the precise details of the exchange offer with its creditors, let alone its medium term economic program.

This process worked: in Pakistan, Ukraine, Ecuador, Russia and Uruguay over 90% of the creditors accepting the debtor's initial offer. A combination of carrots (good deal terms, cash in advance, collateral release in Ecuador, seniority upgrade in Russia) and sticks (exit consents to amend the bond's non-financial terms, and, in Ukraine, to amend the bond's financial terms) resulted in deals almost all creditors decided to accept. Only Russia's restructuring took more than one year, and no restructuring took more than two years.[4] The lack of an SDRM or the lack of collective action clauses (CACs) did not prevent successful restructurings, in part because even bonds that lacked clauses allowing the amendment of financial terms had provisions allowing a majority of bondholders to amend the bond's non-financial terms. Such amendments could be used to make the "old orphan" bonds less attractive to potential holdouts.

A very different new approach is being taken in the Argentine case. First, Argentina's recent IMF program did not define the core parameters for its negotiations with its private creditors, but rather effectively left it up to Argentina and its private creditors to negotiate the Argentina's future primary surplus path. The IMF program did

[4] After the Russian default, the IMF program was suspended and Russia restructured its domestic debt and London Club debt following consultations with creditors. But these partial consultations, not formal protracted negotiations, leading to an exchange offer led to recriminations that the process had not been fair and transparent to all classes of creditors.

set a minimum target for Argentina's primary surplus, one large enough to pay the coupon on Argentina's debt to the IFIs and its "senior" domestic debt. However, the program also indicates that the primary surplus will need to be increased to reflect any payments to private creditors. Given the crucial role of a primary surplus in a country's macroeconomic framework, this approach effectively leaves to the debtor and creditors to bargain over the macroeconomic content of a country's IMF program. Second, rather than taking market soundings and then launching an exchange offer, creditors have organized into a number of committees and want to sit down and negotiate macro targets and deal terms with Argentina. Argentina is being asked to negotiate both the economic program and the restructuring terms with its creditors.

In Argentina, the official sector has come close to abdicating its traditional role of negotiating an economic program with the debtor that outlines, in broad terms, the official sector's assessment of what the country and its creditors need to do to restore debt sustainability. This is a new and unprecedented and potentially quite risky approach to debt restructuring. The U.S. Treasury has taken the views the macroeconomic parameters of an IMF program as interference with a private negotiation between a sovereign debtor and its creditors. However, there are good reasons to doubt whether this new approach will work.[5]

First, it requires an unprecedented degree of coordination among Argentina's private creditors. Argentina's creditors are more diverse than in other recent sovereign restructurings – German, Italian and Japanese retail investors (and their representatives) are sitting at the table with international institutional investors, Argentine pension funds, and representatives of private Argentine investors who bought Argentina's external debt. It will be hard enough for such diverse investors to negotiate restructuring terms that accommodate their different preferences, let alone to negotiate both restructuring terms and the country's macroeconomic framework. Argentine creditor representatives claim that the formation of a limited number of creditor groups that represent a large fraction of the claims in default demonstrates their ability to resolve issues of creditor coordination. But forming a number of creditor committees and then combining those committees into a single umbrella committee does not imply that inter-creditor coordination and bargaining issues have been resolved. Argentina's creditors are likely to be very heterogeneous in their interests, willingness to settle, reservation price and preference for par or discount bonds and other restructuring terms. Forming a committee is only the first step: there is no guarantee that the committee will hold together and be able to take a common position when real decisions that may split creditors have to be taken.

Second, bargaining is likely to be more difficult in the absence of an IMF program that helps to define realistic expectations for either Argentina or its creditors. Creditors are starting from the view that they should get at least 65 cents on the dollar. Market prices of around 30 cents on the dollar throughout 2003 and early 2004 probably provide a more realistic assessment of what the country may, eventually, be able and willing to pay than the creditors initial bargaining position. But there remains a large gulf even between market prices and Argentina's proposed "restructuring guidelines." Argentina's guidelines are not very detailed, but they suggest that Argentina plans to offer creditors new bonds with a face value of 25 cents on the dollar that would be worth

[5] See also Truman (2004) for views similar to ours on the crucial role of the official sector (IMF and G7) in guiding and facilitating a debt restructuring process.

maybe 15 cents in NPV terms. Argentina is also refusing to pay past due interest (PDI). No IMF assessment of debt sustainability has been performed to nudge the two sides toward a feasible and realistic agreement.

Third, the political economy of reform is likely to be harder, not easier, if a country has to negotiate its economic program with its private creditors rather than with an agent of the official sector like the IMF. The idea that a country that has told the IMF that a primary surplus above 3% is politically and socially unfeasible would then sit with creditors and then accept more fiscal discipline and commit to it with its creditors seemed quite far-fetched. It would have been far easier for Argentina to have negotiated a higher primary surplus with the IMF, and then tell its people and its creditors that it could not agree to anything more in its negotiations with its creditors. As it stands, any additional adjustment can easily be portrayed inside Argentina as serving the interest of Argentina's creditors, not the broader interest of sustaining Argentina's economic recovery.

Fourth, it is unrealistic to believe that the official sector – which has more exposure than either European retail investors or more sophisticated institution investors to Argentina – will be a completely passive actor in Argentina's debt restructuring. The official sector simply has too much to lose if the restructuring terms negotiated with private creditors fail to add up or are inconsistent with the debtor's willingness to adjust. It is unrealistic to expect that the official sector will consistently be willing to link its financing to a country's compliance with an economic program whose terms were set by private creditors, or that sovereign debtors will accept such a role for private creditors.

Finally, a passive official sector role precludes any attempt by the official sector to offer carrots or use sticks to get the restructuring moving, as it has done in past restructurings. Potential carrots include reduction of bilateral Paris Club claims to improve the debtor's cash flow, as well as net new financing to the debtor – perhaps to allow the debtor to offer more "upfront cash" to creditors at the time of the deal. As part of the Brady plan, for example, the official sector new funds lent to the debtor funds to buy collateral to back principal and/or interest payments. Given the difficulty and complexity of the Argentine restructuring process, such official intervention – bribes according to some – may be essential to bridge the expectation of the debtor and its creditors and thus facilitate a successful exchange offer. A passive official role could avoid introducing any expectations that the official sector will step in to grease the wheels of a deal, so long as the official sector's commitment is credible. But the worst outcome of all is a bunch of posturing between the debtor and its creditors that leads, after significant delays, the official sector to step in. It would be far better to indicate upfront what the official sector is prepared to put on the table.

The new approach taken by the IMF and the G7 to debt restructuring is unlikely to facilitate a rapid and orderly restructuring of the Argentine debt. More likely, the new process will result in delays, bargaining stalemates and strategic posturing by the two sides. Argentina's restructuring was always likely to be more difficult than other recent restructurings. Argentina's pre-crisis debt levels, the scale of its economic collapse and its need to issue new debt to limit the scale of losses born by depositors in domestic banking crisis require more debt reduction than in other recent cases. The need for deep debt reduction only added to the difficulties created by Argentina's unusually diverse set of creditors. But in our view, the approach taken by the official sector is one of the reasons why the Argentine default already has dragged for over two years and half without resolution, and could still drag out much longer. Creditors would have been better served by a more assertive official sector that more aggressively set the parameters that would guide a deal.

It is possible that the Argentine restructuring will not end-up in a total protracted stalemate. Argentina may successfully resist the creditors' insistence that it negotiate deal terms with a creditor committee, a process that risks complicating reaching agreement if Argentina's creditors themselves can only agree that Argentina should offer more, but are unable to agree among themselves on any concessions to offer Argentina. Argentina wants only to consult and it may be able to avoid a formal negotiation and then launch an exchange offer after "consultations". The IMF may be able to nudge Argentina to improve its primary balance above the 2003 3% target so as to provide more resources for servicing the external creditors' restructured claims. The IMF, the other IFI and MDBs may decide to provide some sweeteners, in the form of new net financing that could help Argentina finance a cash payment to bondholders willing to participate in a deal. Argentina may improve its Dubai offer and present an offer that is closer, in NPV terms, to the current market value of its debt. Clever negotiators know how to wrap some combination of upfront cash, other sweeteners, step-up coupons and accelerated amortizations into menu of restructuring options that seems broadly consistent with Argentina's goal of 75% face value reduction while offering investors something that they would value at close to 30 cents on the dollar. The projected discount that the market will assign to Argentina's new bonds is already falling, and the potential that it might fall further after the bonds are issued leaves plenty of room for a potential compromise between Argentina and its investors. Significant debt reduction does not necessarily imply further losses for investors who mark to market. But the passive laissez faire attitude taken by the official sector does not help a rapid and orderly restructuring.

The core lessons from Argentina to date have not been about the costs created by holdout litigation and resulting free riding on a restructuring deal. While Argentina has attracted more litigation than other recent sovereign debtors, this litigation has been, so far, more of a nuisance rather than a major obstacle to debt restructuring. Argentina has not gotten close to the point of getting a critical mass of creditors to agree to a deal and until most creditors are willing to accept a restructuring, holdout litigation is not an issue. Rather, Argentina demonstrates that the official sector needs to step in and play an active role in the debt restructuring process to try to avert a host of other coordination problems that can lead to delays and economically suboptimal outcomes.

V. Recommended next steps and open issues

Sovereign debt restructurings differ from corporate debt restructurings for a host reasons, most of which do not stem from the absence of an international sovereign bankruptcy regime. No firm issues its own currency, or indirectly backstops the banking system.[6] Sovereign debt is a typically a far more important asset in a country's financial system than the debt of even a very large local firm, so a sovereign default is bound to be more disruptive than the default of a firm. The magnitude of the set of problems that can be solved by introducing a completely new legal regime for sovereign debt restructuring is too small to justify imposing such a regime on reluctant creditors and debtors, with unknowable consequences. We agree with the decision to shelve the SDRM.

[6] See Allen et al. (2002) for a more complete discussion of balance sheet interlinkages.

Many of the basic realities that make sovereign default unpleasant are hard to change. But there still is scope to make improvements in the current system. We specifically recommend:

1. Let majority voting clauses become the norm for sovereign bond issues. Mexico's decision to introduce collective action clauses in its New York law bonds seems likely to have created a new norm for sovereign bond documentation in the U.S. market. U.S.-based investors now seem to have accepted in principle what they have long bought in practice – dollar denominated debt governed by English law with provisions that allow 75% of the outstanding principal to bind in a minority of 25%. Investors have even accepted Uruguay's innovative, "aggregating clauses." It will take time, though, before most New York law bonds contain clauses. In the near-term, debtors will have to rely on the ability to amend a bond's non-financial terms ("exit consents") to limit the risk of holdout litigation.

2. Hope the Southern District court of New York reduces incentives for holdout litigation. The interpretation of the pari passu clause in New York law bonds adopted by the Belgian courts in the Peru-Elliot case increased the risk that holdout litigation will disrupt consensual sovereign debt restructurings. The ruling of the Belgium courts gave holdouts the ability to hold up payments on the new bonds that emerge from a restructuring, vastly increasing holdouts' leverage and the incentive to holdout. But the U.S. courts have yet to rule on this point of law – and it is likely that the Belgian courts will ultimately follow the lead of the U.S. courts. This risk of holdout litigation would be significantly reduced if the U.S. courts adopt the more traditional interpretation of the pari passu clause supported by the U.S. Treasury, the New York Fed (both of whom have filed *amicus* briefs in a recent court case) and a number of legal scholars (see Pam and Buchheit (2003)).

3. Only move forward with a code of conduct if the code focuses on disclosure rather than addressing the full panoply of creditor complaints. It is reasonable to expect that a debtor should provide full, timely and accurate information about its debt profile and restructuring plans to its creditors. Debtors also will need to consult with creditor representatives to develop a restructuring proposal. But debtors should not be required to reach agreement with every member of a creditor's committee before launching an exchange offer. That would introduce a new source of delays into the current restructuring process. Nor should a debtor be expected to restructure external and domestic debt on the same terms. Perfect equity may not even be in the interest of external creditors: a domestic debt restructuring that triggers a bank run that could ultimately result in lower recovery levels for external creditors. The IMF must balance a series of different objectives after a default. It should not focus its conditionality exclusively on enforcing an extensive code of debtor conduct.

4. Recognize the IMF has a key role to play in the restructuring process. The IMF's hand-on role in the restructuring process is part of what makes the sovereign debt restructuring process work in the absence of the supervision of a bankruptcy court, not an unwarranted official interference in a private commercial dispute. The IMF should design a medium-term economic plan for the country and make a broad assessment of the level of debt payments that are consistent both with the debtor's adjustment path and debt sustainability. No other actor is in a position to help coordinate the overall restructuring of all of the sovereign's domestic and external debt. If IMF financing can help prevent a

devastating bank run or the complete collapse of the currency, the IMF should be willing to provide financial support to a country going through a debt restructuring. At times, it even may be appropriate for the IMF to provide financial incentives to facilitate a deal.

The case for introducing collective action clauses should rest on the argument that the collective action problems arising from holdout litigation are conceptually among the easiest of the problems that arise in a sovereign debt restructuring to solve. Mexico, and even more so Uruguay, have identified a set of contractual changes that could significantly reduce the risk that holdouts would have the legal leverage to be able to disrupt a debt restructuring. There is no evidence that introducing such clauses will dilute an issuer's incentive to pay. The gradual introduction of collective action clauses will not suddenly make a sovereign debt restructuring fast, painless or easy, nor will they guarantees that debtors will decide to seek necessary restructurings more quickly. Indeed, it is doubtful that debtors delay right now primarily because some existing bond documentation fails to provide for a majority vote to amend key financial terms.

Argentina has served as a useful reminder that holdout litigation – and the delays that may emerge from steps the sovereign takes to limit the risk of holdout litigation – is not the most important problem that arises in a major sovereign debt restructuring. Default on sovereign's debt typically leads to a run on the country's currency, a run on the domestic banking system (unless deposits already have been frozen), and a rush to sell other domestic financial assets, all of which augment the real economic costs of the restructuring. Sometimes the IMF may be able to use its ability to lend when others cannot to help the debtor avoid the worst of the financial chaos that follows default; sometimes the IMF may have exhausted its lending capacity trying to help the debtor avoid default (as in Argentina) and be unable to help. In all cases, though, the core challenge after a default is to find a way to coordinate the restructuring of all the individual debt contracts that define the sovereign's total restructuring with its overall adjustment effort, and to ensure that the overall result lays the basis for a sustained recovery.

References

Allen, Mark, Christoph Rosenberg, Christian Keller, Brad Setser and Nouriel Roubini "A Balance Sheet Approach to Financial Crises", IMF Working Paper 02/210, December 1, 2002.

Roubini, Nouriel and Brad Setser (2004) "Bailouts or Bailins? Responding to Financial Crises in Emerging Markets," forthcoming, Institute for International Economics, Washington, D.C.

Roubini, Nouriel "Do We Need a New International Bankruptcy Regime? A Discussion Paper" Brookings Panel on Economic Activity, Fall 2002.

Truman, Edwin (2004) "What Next for Argentina?," Institute for International Economics, Washington, D.C., February.

Pam, Jeremiah and Lee Buchheit (2003) "The Pari Passu Clause in Sovereign Debt Instruments," unpublished, Georgetown University, December.