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International Affairs Working Paper 2006-02
January 2006

This is a revised version of a paper prepared as background for the joint project of the Graduate Program in International Affairs of The New School and the Carnegie Council on Ethics and International Affairs, with support from the Ford Foundation, called "Ethics and Debt". The paper has benefited from comments by Christian Barry, Lydia Tomitova, and Alys Willman-Navarro. Views expressed are those of the author and not necessarily of any institution with which he might be associated.

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ABSTRACT

Is there “justice” in treating developing country debt crises? As a first step toward analyzing ethical questions in sovereign debt, this paper characterizes the actors, their main interests, and how they operate during the build up of government foreign debt and after a default on payments. These actors are the borrowing governments, domestic and foreign commercial banks, purchasers of government bonds, other governments lending to the debtor, and multilateral institutions (International Monetary Fund and development banks). As there is no international sovereign analog to court-supervised bankruptcy, the workout from crisis is found ad hoc, without rules or an enforcement mechanism.

THE PLAYERS AND THE GAME OF SOVEREIGN DEBT

Barry Herman

In policy discussions about government debt, especially of developing countries and particularly in cases when there is a crisis to overcome after a government defaults on its debt, commentators often talk about legal obligations, political necessity, and economic consequences. Implicitly or explicitly, commentators refer to what the "proper", "fair," or "just" actions would be. Typically, what is claimed as fair from the perspective of one group of interests (for example, the holders of defaulted government bonds) is regarded as unfair by another group (for example, the people whose taxes would be raised to pay the bondholders), and vice versa. Ultimately, a compromise is almost always reached between a sovereign debtor in crisis and its creditors. It is a compromise voluntarily entered into by the parties, under rules of negotiation accepted by all sides, including that the parties are unequal in negotiating strength. But does that mean the compromise represents a fair sharing of the burden among the different players?

Presumably, sometimes the result is fair and sometimes it is not. That may not be very satisfying and other approaches to resolving sovereign debt crises have been conceived. However, none has been found generally acceptable. All the reforms introduced thus far in renegotiation of sovereign debt have aimed to clarify the rules or facilitate reaching a conclusion under them. It is "the only game in town" because all others are deemed inferior by enough of the players to block a change of the game. Perhaps this is not fair, but if so how does the world get to an alternative that is fair?

While the operative parts of these questions are policy matters, they seem to beg for assistance from people practiced in discussion of ethical issues. Before seeking their help, however, it seemed useful to try to explain in some detail what the sovereign debt game entails, who the major players are, what interests they seek to fulfill, how they interact, and some of the challenges that they face.[1]

THE SOVEREIGN DEBTOR

Sovereign indebtedness begins when the national or central government of a country chooses to borrow. The typical borrowings are uncollateralized obligations of the government in domestic or foreign currency, backed only by its "full faith and credit." This debt is recognized as an obligation of the government as a whole, and the executive and legislative processes of the government manage it. The judiciary is responsible for assessing purportedly criminal actions relating to sovereign debt and settling disputes between the government, its creditors, and financial intermediaries in matters pertaining to government debt issued under domestic law. The courts of the borrowing country are not typically considered (by its creditors) as the relevant forum for settling disputes involving the government's debt issued under the laws of other countries, such as bonds issued in New York or London. The borrowing government may be bound by its constitution and accepted practice to abide by the decisions of its own courts, but there are no treaties by which governments are required to cede authority to any foreign court in matters of sovereign debt.[2] Only moral suasion, political pressure, or economic threats can make the government

[1] A companion paper by Christian Barry ("Ethical Issues Relevant to Debt") seeks to identify a number of ethical concerns in sovereign debt as seen from a philosophical perspective. As the primary intention of the present paper is to make sovereign debt as a policy issue more accessible to philosophers, the other paper seeks to explain to economists and financial experts what questions philosophers might wish to discuss in approaching the same problems.

[2] In the United States and United Kingdom, where most international borrowing is arranged, sovereign governments are considered immune from lawsuits except when they engage in "commercial activity."

honor the decisions of foreign courts.

Types of government borrowing

Governments typically borrow for three main purposes: short-term transaction smoothing, medium-term expenditure smoothing, and investment in specific, usually longer-term projects, such as improvements in infrastructure. The first type of borrowing includes loans, usually for up to ninety days, typically from domestic commercial banks, which make it possible for expenditures to follow different cycles than revenues. The borrowing during months of revenue shortfall is repaid during the months of surplus. Comparable loans in foreign currency are taken to smooth international transactions over time, which helps to limit short-term volatility in the exchange rate. The average level of short-term government debt related to such borrowings usually grows more or less at the rate of growth of overall domestic economic activity, while the foreign currency component of such debt grows roughly in proportion to the growth of foreign trade and payments. This type of borrowing does not lead to sovereign debt crises.

Governments often also borrow during economic recessions in response to unplanned declines in tax revenues and recession-related increases in expenditures. The alternative to the borrowing is to cut expenditure or raise taxes in response to the revenue shortfall, which would aggravate the recession. All too often in recent years, developing countries with very limited borrowing capacity have had to follow such so-called pro-cyclical policies. The quid pro quo when instead undertaking "counter-cyclical" borrowing is that the government should repay the cycle-related debt during the next boom period, which entails running a budget surplus. This is to say that although the original maturity ("tenor") of the loans undertaken during the downturn could be anything up to, say, ten years or more, the government should either repay them during the recovery period or not roll over other loans as they mature. As a result, over the full economic cycle the net borrowing would be nil. Problems arise when the net borrowing over the full cycle is excessive. This could happen when a sequence of adverse economic shocks repeatedly postpones recovery, or when a permanent adverse change is mistaken for a temporary recession. It could also be the result of policy failures of the borrowing government, such as not restraining expenditure during the boom when high demands are made on the argument that now "you can afford it."

Governments also borrow for specific policy purposes, for example, to purchase military hardware, or for specific long-term investments, such as constructing or improving highways or ports. While the "useful life" of some military hardware may be up to a decade, some infrastructure (with proper maintenance) will last a generation or more. Because such investments benefit residents over time, it is generally considered fair that the future beneficiaries of these investments bear some of their costs. Thus, instead of asking the current taxpayers to bear the full cost, governments borrow and share the cost with the future taxpayers through interest and principal repayments. Indeed, as infrastructure investments can raise economic growth, they can thereby also enhance the capacity of the borrowing government to service the debt out of higher tax revenues it collects on the higher incomes. There is nevertheless an important caveat in that very heavy borrowing for capital investment can place an excessive debt burden on the populace in the future.

Government borrowings discussed thus far should all appear in its fiscal accounts (and in those of the central bank when it undertakes external borrowing on behalf of the government). Government debt may also rise in less transparent ways. For example, for policy reasons the government may guarantee the borrowing of another entity (state

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Government borrowing is considered such an activity (and explicit waivers of sovereign immunity are standard clauses in loan or bond contracts). However, this only means that a private creditor can sue a sovereign debtor in court in New York or London. Winning a settlement is rare, and collecting on it is far rarer still.

enterprise, public-private partnership, even private company). As the government is usually deemed a lower credit risk than any other domestic entity, a government guarantee lowers the interest cost or extends the maturity of the borrowing by the favored entity. In that sense, issuing a guarantee is an attractive policy tool as it can assist the targeted recipient and yet it is not an actual budget outlay. In the event of default by the entity, however, the government becomes responsible for the repayment of the loan—that is, the guarantee creates a "contingent liability."

Governments may also incur debts without guaranteeing a specific loan, as when they have to borrow to make up a shortfall in promised payments, as to retired civil servants owing to insufficient provision or bad investment experience of their pension fund. In this case, the government guarantee is to the pensioners and exemplifies a class of contingent claims that can be labeled "unfunded obligations." Sometimes, governments even have to incur debts to make good on obligations on which there are at best only implicit guarantees. One example is borrowing to recapitalize the local commercial banks in a generalized banking crisis. In such cases, the government may buy a portion of the bad debt held by the banks using funds it borrows itself. The new financial resources transferred to the banks are meant to rebuild confidence in them, without which no market-based economy can function.[3]

In sum, most categories of government debt are intentionally incurred, although unfunded obligations and contingent liabilities can add to government debt in an unplanned way. It is usually difficult to forecast when or with what probability such contingencies would require new borrowing, but the probability is not zero. In that sense, official government debt statistics understate the fiscal condition of the government, albeit by an amount that is difficult to measure. More generally, economic shocks can turn what appeared to be responsible budgeting into a debt crisis. The latter arrives at the moment when the government's usual creditors lose interest in extending further loans.

[3] It is widely held that taxpayers are justified in insisting on government regulation and supervision of privately owned banks in a market economy precisely because of this contingent claim on them owing to the essential public service that banks provide. This is an additional argument to the perhaps more standard one that deposit insurance should be coupled with official supervision to reduce the claims on the insurance fund from failed banks.

The art of sovereign debt management

To assist governments in their debt management, the international policy community has been trying to specify guidelines for what the "sustainable" level of government debt might be. However, there is no global consensus yet on the factors to include in an operational definition, let alone how to monitor them, and certainly we are far from agreement on any general guidelines for maintaining sustainability. Given the proliferation of debt crises over recent decades, however, the International Monetary Fund (IMF) now prepares a standard report on sovereign debt as part of the mandatory annual consultations with governments of member countries on their macroeconomic policies. The report examines alternative economic scenarios and potential economic shocks and traces what happens in each case to standard debt indicators (for example, ratio of total debt to gross domestic product and foreign debt to exports of goods and services). Examination of the "debt dynamics" is meant to signal under what kinds of economic circumstances the country might become vulnerable to a debt crisis, although as noted above, actually having one requires that the usual creditors lose confidence and cease lending, which is impossible to foresee.

Regardless of how difficult it may be, the government is regarded as responsible for managing its own debt. It may take a very cautious approach to borrowing, which lowers the probability of crisis. But this would be at the cost of foregoing the benefits from borrowing, which could be in moderating an economic downturn or in enjoying the services of particular infrastructure investments. The amount of risk to carry is thus properly a political decision, which means it should be taken by the appropriate political authority of the government (executive and/or legislative). The international community of states could decide to share in this risk if it provided automatic credit lines to governments that are deemed to budget "responsibly" so that there would be some form of adverse risk insurance. Thus far, it has not chosen to do so. IMF lending usually comes after the crisis starts and is contingent on accepting a long list of policy conditions (except for a modest "reserve tranche"). The risk and responsibility is left fully with the government.

Why do governments service their debt?

At any moment in time, a government's debt is the cumulative result of the borrowing and repayment by it and all previous governments. When the government is considered legitimate and seems generally to represent the wishes of its people, the debt is viewed as the collective obligation of the people and should be serviced by current and future governments, as contracted.[4] In fact, governments almost always do service their debts. When a new government is formed, it inherits and almost always accepts responsibility for all of the debts that were obligations of the previous regime. Governments do this for the same reason private sector borrowers do: the government wants continued access to credit from all its creditors and on as favorable terms as possible. Anything else threatens to make governing more difficult.

Moreover, in the case of debts incurred for constructing infrastructure that continues to provide services (roads, school buildings, etc.), the change of regime should not matter. It was understood when the loans were incurred that they would have to be serviced over successive governments and the services from the investments are enjoyed by taxpayers under the new as much as the old regime. However, if the infrastructure investment had been grossly overpriced or is deemed dangerous to public health and safety, the investment agreement, including its financing, might be revisited (indeed, the government that signed the initial contracts may equally challenge the deal if it comes to suspect malfeasance). Governments are nevertheless cautious in challenging investors in such cases so as not to discourage investors in other projects. Specific cases of fraud or bribery are more easily pursued than general claims that all lending to a previous regime constituted "odious debt"

[4] This point is elaborated in Christian Barry's paper.

that should not be serviced. Concerns to bring such ethical considerations to bear are typically swamped by desires to maintain as much space as possible in which to govern.

Nevertheless, a government could reach the conclusion that its previous history of borrowing was so economically and socially harmful that it decides to eschew future borrowing. In this situation, the government may feel less impelled to service its already outstanding loans. Indeed, this argument was made in Argentina, following its default at the end of 2001. Argentina, however, "cured" its defaulted debt in 2005 and returned to the financial markets.

CREDITORS

It is necessary to discuss the different classes of creditors separately, as they have different motivations, expectations and behaviors in their acts of lending to a government, which might lead to different judgments about their obligations with respect to servicing that debt.

Commercial banks: bedrock of the financial system

Inside the banks

The loan officers of banks are expected to regularly assess and monitor the sustainability of their clients' borrowing. Banks also maintain risk management offices to oversee that the overall portfolio of loans extended by the bank is not excessively risky. This involves both questions of the mix of loans and the riskiness of individual clients. Moreover, as commercial banks are regulated institutions, the supervisory authorities are also obligated to monitor the riskiness of the portfolio of loans of the banks.[5]

In fact, banks are regulated because they tend to take on excessive risk when attracted by the prospect of profit. Because banks charge riskier clients a higher interest rate, lending to them is more lucrative, at least as long as they service their debts fully and on time. Management may discount warnings coming from their risk managers, especially as most banks are corporations whose shares trade on the stock market, and whose management is remunerated according to stock-price movements, which usually reflect short-term profit performance figures.

The responsibilities of loan officers and risk managers to their bank are the same whether the bank is lending to the government or private clients. However, the banks are likely to voluntarily lend longer to their government when its debt indicators are worsening than to a private firm. One reason is the presumption, which is warranted by history, that the government is a less risky client than private entities (it has taxing authority, which is unique).

However, banks may also lend when they would rather not. Banks exist in a political world and their governments can first pressure and then force the banks to continue to lend beyond what they would do voluntarily and can press "forbearance" on the part of regulators.[6] The hesitation to lend voluntarily as a domestic situation worsens is weaker in the case of domestic banks that lend to their government in local currency. The concern is typically less about outright default by the government than erosion of the value of loans owing to inflationary money creation. But domestic banks can also accommodate themselves to political pressure—as long as it is put on all of them together—to lend to their government in foreign currency (which means either borrowing abroad on their own account for lending to the government or selling some of their other foreign currency assets

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[5] In light of the greater complexity and speed of banking transactions today, regulators have increasingly focused oversight on the methods ("models") used for risk management instead of the contents of the loan portfolio itself at the moment of the regulators' visit, especially for the larger, internationally active banks.

[6] Vulnerability to pressure to continue lending is especially the case for banks that are government owned, many of which still exist in developing countries.

to raise funds to lend to the government). They can tolerate the risk of such lending because of the "moral hazard" problem: the banks know that as long as they are all "in the same boat", should there be a general domestic banking crisis owing to a government default on its foreign currency obligations, they will have to be bailed out as a group since functioning banks are essential to the economy.

A scenario of this sort played out at the international level in the 1980s, when the large "money center" banks based in the developed countries that had lent large sums to developing countries put the entire international monetary system at risk. When the bubble burst, rather than accept the bankruptcy of their client governments, the big banks joined together and in cooperation with IMF and the major country governments continued lending for several years, while their regulators looked the other way.

On the other hand, during normal times, bankers typically press their governments for "responsible" macroeconomic policies as seen from their perspective—that is, low-inflation policies that continue to provide relatively low-risk opportunities to lend to the government and varied opportunities to lend to the private sector, which is usually more profitable. They may exert pressure on governments for "sound" policies individually or through local business associations. In addition, after the 1980s debt crisis the major international banks have increasingly lobbied together globally, as through the Institute of International Finance, based in Washington, D.C.

Large-scale international bank lending and its crises

Private international lending only emerged as a major form of international financial transfer to developing countries in the 1970s. It primarily took the form of international bank loans in foreign currency to governments. Banks had traditionally lent to governments to finance capital-equipment imports, such as airplanes or locomotives. However, these export credits often were (and still are) guaranteed by an official agency of the exporting country, and have thus been of low risk to the banks. However, beginning in the 1970s, the banks also made large-scale, multi-bank loans to governments for general fiscal deficit financing, to replenish foreign exchange reserves, or for other purposes of such kind. It was this latter type of lending that created much of the foreign bank debt that ultimately had to be restructured by overindebted countries in the 1980s and early 1990s.

In this type of lending, the currency of the loan is the central issue in the prospect of default. As noted above, the government can usually service its domestic currency loans through additional money creation, albeit at the price of additional inflation. The government cannot create foreign money, nor can it mobilize it once it empties its reserves and loses access to new international credit. All it can do is notify the creditor banks that it cannot make its next payment and seek to restructure the obligations. In this regard, banks have to assess the "credit risk" in lending to a foreign government (risk of nonpayment), and they charge a risk premium above a risk-free interest rate as compensation for taking on the perceived risk of nonpayment.[7]

Although 1980s-style multi-bank lending to developing country governments has largely departed the international scene, it is useful to recall how the sovereign defaults to international commercial banks were resolved. The loan agreements themselves embody part of the story. That is, most of the large-scale bank lending was in syndications in which many banks—sometimes up to 500 or more—would participate. The cross-default clause in the loan contract typically said that any default against one of the banks was a default against all of them. Funds that were recovered on a defaulted loan also had to be shared with all the other banks in proportion to their share of the debt. In short, the banks were pushed

[7] The risk-free rate was typically the rate that the major banks charge each other for loans in London, the world's deepest financial market. As sovereign bank loans usually paid interest semi-annually, the interest rate would be calculated as the six-month London inter-bank offer rate (LIBOR) plus the pre-set risk premium.

by their loan contracts to negotiate together with the government to resolve the situation. The lead managers of the loan syndicates usually led the negotiations, after forming ad-hoc Bank Advisory Committees or London Clubs, so named because many of their meetings in the 1980s took place there.

This negotiating structure for the banks also turned out to be efficient for the sovereign debtor who only had to deal with a limited number of negotiators. However, it did not indicate what the debt workout should look like. In the early years of the 1980s crises, the governments and banks seemed to have a common interest in avoiding a formal state of debtor default. The emphasis then was put on "concerted" or "forced" additional lending by the banks acting collectively so the loans could continue to be serviced.[8] They were buying time while they hoped for recovery and the sovereign's return to repayment capacity. However, this ruse could not last. Inevitably, the question became how to share the losses from the actual insolvency.

There were essentially two sets of interests among the banks. Some of them had invested in the domestic banking sector of the debtor country and had long-term interests to protect. Their desire to recover on the defaulted debt had to be set against not wanting to jeopardize their other businesses in the country. Others had no long-term relationship with the debtor country and were only interested in recovering their funds. As the 1980s wore on, many of the latter banks lost patience and decided to cut their losses. They sold their shares in the loan syndicates at deep discount to speculative investors in a new market in nonperforming debt. However, the investor who purchased his loan share at 30 cents on the original dollar of loan would make a very good profit if the final deal netted him 60 cents on the dollar. And so, eventually deals were struck among the remaining creditors and with the debtor.[9]

Today, London Clubs still form to deal with sovereigns that encounter difficulties with their bank debt, but there is little interest in arranging any more forced lending. In the 1990s crises, the banking community instead looked to the multilateral lenders, especially the IMF, to provide governments with the resources to keep the loans of the banks "performing." By the end of the decade, however, governments of the major creditor countries reacted negatively to their experience with large-scale lending to stave off defaults of countries in crisis (although they did not lose a penny). Instead, they sought to limit the amount of official lending in such situations, preferring to see the banks take losses in acknowledgement of the risk of their lending. In the parlance of international financial diplomacy, this has been called "involving the private (creditor) sector in crisis resolution." The terms of this bank-government relationship continue to evolve, but whenever a London Club is formed today it is understood to require dealing with an insolvent government and that the creditors may need to take a "haircut," i.e., accept less than full repayment of their loans.

Purchases of government bonds

Large-scale syndicated loans by internationally active banks are a much less common form of international lending today than they were in the 1980s because the international bond market has retaken its historical (nineteenth-century) role in arranging large-scale foreign

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[8] Left to their own devices, each bank could have waited for the other banks to lend the funds to prevent a formal default; only by bringing the banks together and jointly agreeing to lend the country the funds to continue to service the loans could outright default be avoided, which thus became known as "concerted" or "forced" lending.

[9] In the final set of debt workouts for the 1980s crisis, IMF and international development banks lent additional funds to the governments to help them purchase so-called zero coupon U.S. Treasury bonds (these bonds pay the total sum of their interest upon maturity of the bond). As the value of these bonds at maturity would equal the debts falling due, they guaranteed repayment and sweetened the final restructuring deals.

lending. One reason for the increased popularity of bonds as a funding instrument is that it is easier for the banks as well as other creditors to buy (and sell) government bonds than it is to participate in loan syndications. Bonds are standardized financial "instruments" that are usually traded on markets, making them more liquid (that is, they could be sold more readily) than participations in syndicated bank loans (which could also be sold, but in a "thinner" market, one with fewer trades).

Usually, the first markets in financial instruments to develop in a country are the markets in government "paper," beginning with short-term notes and eventually involving longer-term bonds. The government is the best known and least risky issuer in every domestic market. The buyers of its bonds are usually domestic financial institutions (banks, pension funds, insurance companies) and wealthy individuals.

An international market for government bonds in "hard" currencies (those of the highly-industrialized countries) first re-emerged in the post-war era with developed country issuers in the Euromarket. Developing country governments thus only had to gain acceptance as issuers in an already existing market that had already standardized financial instruments. In addition, from the beginnings of the "Eurobond market" in the 1960s until late in the 1990s, governments rarely defaulted on their foreign bonds, making them seem lower risk credits than bank loans.

More recently, foreign demand has begun to grow for government bonds issued on the financial markets of the larger developing countries, albeit first for dollar-linked domestic currency bonds and other types of securities, and then local currency bonds themselves. The increased willingness of international financial investors to hold local currency bonds of emerging economies is indeed a major step in financial globalization.

Main players in the international bond market

Several of the major internationally active commercial banks of the 1980s (or their post-merger successors) now make up some of the most important intermediaries in the emerging economy sovereign bond market. In this business, the commercial banks have taken up a bigger role in the core business of "investment banks" ("merchant banks" in the United Kingdom), which advise governments on how, where, and when to issue their bonds, help them to structure the bond offerings, take care of the initial marketing of the issue, and underwrite the issue as they effect their sale to first buyers (the contrast is with commercial banking per se, when the banks lend their own money).

International investors generally see government bonds as part of a portfolio of securities that they hold. The trick for the "portfolio manager" (whether individual or a firm) is to strike an appropriate balance among a variety of financial assets with different risk and return characteristics so as to give some targeted average yield in exchange for an overall level of risk. The portfolio manager may buy and sell securities continually as he or she seeks to adjust to changing perceptions about the securities in the portfolio. In the developed countries, bond buyers usually see lending to their own government as a safe albeit generally low-yield investment. Own-government bonds are thus a standard part of most investment portfolios in developed countries, although in different proportions of the total invested, depending on the investor's ability and desire to be exposed to risk in exchange for taking the chance for greater yield. Foreign government bonds, in particular those of emerging economies, are still viewed as high-risk and pay a relatively high return.[10]

Whether in developed or developing countries, it is considered the responsibility of the so-called buy-side institutional investor or purchasing household to choose its portfolio of investments wisely and not to subject the portfolio to greater risk than intended. There is a presumption that the institutional and individual investors are capable of doing this, i.e.,

[10] From the developing country government's perspective, the interest paid on foreign-issued bonds in hard currency may be a small fraction of that paid on domestic currency bonds, where the interest rate and inflation environments are very different.

that they have the capacity to assess the financial situation of the issuers of the securities they hold, including those of their own government and any other government whose bonds they buy.

Private and independent bond-rating agencies exist to help the buy-side make its assessments. It is considered to be the interest of the bond issuer that the market has credible information on its bonds—and indeed, the ratings industry lives off the fees paid by bond issuers for the assessments the agencies make of them. Moreover, government regulators of pension funds and other financial institutions heavily restrict the bonds that the institutions they oversee can hold, often requiring that only the bonds qualify that pass a particular hurdle rating ("investment" grade). Nevertheless, it is clear to all professionals in the market that the rating agencies are only making judgments of the probability of default on the bond. They issue no guarantee and have been charged with being slow to react to changing circumstances that warranted a revised rating of the issues of a particular country or firm. Indeed, most institutional investors make their own assessments of the riskiness of any individual bond, using the rating agency's grading as only one input into their assessment.

Whatever the extent and reliability of the information available, those providing it—market research firms, research departments of merchant banks, rating agencies—are not held financially accountable if the information proves false, as long as the information was provided in good faith. The same holds whether institutional investors or households use the information to buy foreign or domestic currency bonds of their own government or of corporate issuers or of foreign governments.

While the presumption that the buyer/investor is responsible for being well informed may seem reasonable, things become much less clear if financial intermediaries have misrepresented the true risks of the government bonds being purchased by a household or by a buy-side intermediary, such as a mutual fund. What if the issuing government then defaults on those bonds? If the distortion was intentional, the sell-side intermediary is presumably guilty of fraud and should make the buyer whole. If the government issuing the bonds has withheld information relevant to the buy-side decision, the bond-issuing government should arguably be held responsible. In the latter case, perhaps the government officials would be found guilty of a crime, and the public in the debtor country would be responsible to make the creditor whole. When there is no fraud, the principle of *caveat emptor* ("buyers beware") generally prevails.

What happens in a bond default?

The bond itself is a contract between the issuing government and the holder of the bond by which the government promises to service the bond fully in accordance with its terms. The government that defaults on its bonds unilaterally breaks the contract and the contract stipulates what happens next. The default usually begins with the government advising the bondholders that it cannot make the next debt servicing payment falling due. Unlike bank loans, which are kept on the books at nominal value until a decision is made to declare them "impaired" there is no hiding from the loss in value of the bonds after the debtor's announcement. The bonds are available for trade continually on international markets and at the end of each day the institutional investors "mark to market" (recalculate the value of their portfolios at closing prices of each security held).

After a grace period, the bond may be "accelerated" by the bondholders—that is, the government becomes obligated to repay the whole bond immediately and fully, which of course it cannot do. Unlike some of the provisions in bank loan contracts that drive the lenders together, individual bondholders have strong incentives to try to collect what is owed to them individually, which may start a "race to the courthouse" to try to attach assets of the debtor government in lieu of the defaulted bond. However, there is usually very little to attach (for example, all diplomatic property is off bounds). It is also never cheap to begin a legal proceeding against a defaulting government and the outcome is uncertain.

It has always been possible for a government that anticipates trouble to ask its bondholders to restructure the repayment obligations.[11] Most emerging economy bonds are issued under New York law, and until recently the standard contracts made a negotiated restructuring of repayments virtually impossible, as they required approval of all bondholders. There has been a way around this—called "exit consents"—by which the government offers to swap the old bond on which it could not meet its obligations with a new bond and as part of the deal the bondholders agree to change the nonfinancial terms of the old bond in such a way as to make the old bond virtually worthless. This works because to change the nonfinancial terms usually requires only a simple majority of bondholders. However, with the recent introduction of "collective action clauses" (CACs) into developing country bonds issued (or "floated") in New York, there is now a practical mechanism (which existed all along in bonds floated in London) by which the government could directly approach its bondholders to change the financial terms of the bond before (as well as after) it defaulted. The bond contract will say what specific majority is required to effect the change and how the bondholders are to be mobilized. If accepted, the government then commits to fully meet the new terms.

Over the next ten to fifteen years, as new bonds with CACs increasingly replace maturing old bonds without them, it should become easier to mobilize the holders of individual bond issues to renegotiate with the insolvent debtor government. This is, however, a rather minor reform. In particular, it involves no built-in mechanism for bringing the holders of all outstanding bond issues of the debtor together to restructure their obligations (called the "aggregation" problem). It is of course attractive to the debtor if the bondholders form themselves into a single bondholders' committee with which it can negotiate, and large institutional investors that hold several different issues of a country's bonds may also have an interest in forming a single creditors' group.[12]

Even if CACs lead to better mechanisms for bringing the bondholders together for negotiation with the sovereign, this does not tell us the direction in which the negotiations themselves would move, in particular in light of the Argentine experience. That is, it took four contentious years, during which there were many fruitless attempts to bring the government to court, before Argentina's defaulted bond debt was finally restructured. This experience would seem to make a more cooperative approach to negotiations more attractive to the creditors and the debtor in the next case of default. On the other hand, Argentina's unprecedented debt reduction may encourage defaulting debtors to toughen their negotiating stance, making for a more protracted negotiation.[13] So too might the very positive reception the international financial markets gave to two new Argentine bond issues floated almost before the ink was dry on the final restructuring of its defaulted debt.

In all such cases, bondholders risk more a partial than a complete loss in the event of sovereign default. The crucial question is how much loss the bondholders and other parties

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[11] In fact, the simplest way to accomplish the same thing would be to borrow to cover the payments falling due and repay that loan later; thus, asking to restructure a bond means the government's reputation has already sagged so much that it has lost "access" to the market and cannot issue new bonds.

[12] One contentious issue between governments and private creditor representatives (as expressed in discussions of a prospective "code of good conduct" for sovereigns and their private creditors) is who should pay for the expenses of a creditor committee. The reader may imagine how the different sides of this dispute align themselves.

[13] Having defaulted at the end of 2001, Argentina made a take-it-or-leave-it swap offer of new bonds for old at about 30 cents on the dollar in early 2005 and its Congress essentially declared that any original bonds remaining after the swap would be null and void; Argentina had claimed its bondholders had all along refused to enter into serious negotiations despite trying to engage them. The bondholders, on their side, said it was hard to negotiate, since the government was asking them to absorb unprecedented losses, which most of them did, as in the end 76 percent of the bondholders agreed to the swap.

should bear under different sets of circumstances. Today there are no general principles to govern or guide how much loss should be asked of the bondholders, nor whether bondholders, the banks, nor any other commercial medium-term lenders should receive the same or different "haircuts" in a debt workout for a sovereign in financial crisis. If it is not obvious that the haircut should be the same for all, then which subcategories of each type of creditor should be treated differently, and in what ways? Another question that has vexed government and private creditors is how the private creditor haircut should compare to that on debt owed to other governments. Finally, would it be just if other parties who are neither the debtor country nor the creditors absorb some of the loss, especially if they could do so at a relatively low cost (for example, in treating the debts of the poorest countries, bilateral aid donors have contributed amounts to cover poor-country obligations to the World Bank that were unrelated to the size of their own loans to the country).

Government creditors and the Paris Club

Government-to-government lending is a different category of international finance from private lending to governments. For many governments of developing countries, especially the poorest ones, official lending is the main source of foreign credit, but even middle-income countries owe some debt to other governments. Most of the loans to the poorest countries are highly subsidized. Many are offered as official development assistance (ODA), or for military equipment purchases, or for emergency humanitarian assistance (although the latter is probably mostly grant assistance now). While there are exceptions, such loans are usually repayable in the currency of the lending government. Most of the lending is of a medium-term nature, and a large part is contingent, wherein the creditor government guarantees the loan of a private lender (usually a bank), promising that the guaranteeing government will cover the obligations should the borrowing government default.

A large part of the loans and guarantees are of a commercial nature, primarily credits to promote the export products and services of the lending government's economy. However, the lending or guaranteeing export credit agency is not a private or for-profit entity. Governments create such agencies for policy purposes. Unlike a private corporation, the export credit agency does not need to report quarterly profits to the market, which investors can scan when deciding whether to buy, hold or sell equity shares. But the export credit agency is mandated to cover its costs (or not exceed its budgeted subsidy). Losses will displease its government overseers, thereby potentially threatening its resource stream, and hindering the professional prospects of its managers. Its mandate entails a moderate subsidy of exports, but nothing more. Thus, officers of these agencies can be expected to have a similar responsibility to be informed about the repayment capacity of the borrowing governments as private creditors. Also, like private creditors, they will make great efforts to recoup their loans when the borrower defaults.

When a borrowing government defaults on officially guaranteed export credits, the guarantor government pays what is owed to the private creditors, takes over the obligation directly, and seeks repayment from the defaulting government. The creditor government equally will seek repayment of any of its direct loans on which the debtor government defaults, including ODA. It does not seem to matter in practice if the defaulted repayment is on an ODA loan, collection of which might itself compromise the development capacity of the borrowing country. It seems that the pursuit of development assistance goals is overridden by the exercise of the lending government's "creditor rights" in its credit recovery negotiations with the debtor.[14]

[14] This is not to deny that ODA debt is in practice often treated differently, nor that several creditor governments long ago converted all their ODA loans into grants; it is rather that the practice is not universal and considerable bilateral ODA is still given as loans and repayment is insisted upon and renegotiated as part of debt restructurings after recipient governments default.

A borrowing government usually defaults on the loans of all government creditors at once. Each creditor wants to recover all of the funds owed to it, but the very act of default signals that the debtor cannot satisfy all of them. Rather than compete against one another to recover what they can, the main government creditors formed the so-called Paris Club in the 1950s, and have since then jointly negotiated their overall debt relief package with the debtor government, guided by an assessment of the financial needs of the debtor as prepared by the IMF. In general, the Paris Club does not reduce the level of debt but instead postpones payments, capitalizes unpaid interest, and charges market interest rates on all the outstanding amounts.

In essence, the basic Paris Club agreement is thus a refinancing of the debt, buying time for the debtor economy to recover and resume the debt servicing. The Club typically addresses only part of the problem at any sitting about a given country, rescheduling debt payments over a one or two-year period, requiring a sequence of visits and agreements. This "short leash" approach is meant to add pressure on the government to that of the IMF to follow policies deemed corrective of the debt crisis. However, the Club has also made special "deep" relief arrangements for certain politically important cases (Poland and Egypt in the early 1990s and Iraq and Nigeria most recently), and it has adopted different policy frameworks for dealing with special situations. The most notable is for the heavily indebted poor countries (HIPCs), which can receive substantial reductions in the stock of their debt and the new Evian Approach, which opens the possibility of debt reduction in special cases for countries outside the HIPC process.[15]

The result of a Paris Club negotiation, called an Agreed Minute, specifies only the general terms of the debt restructuring deal (such as how much debt will be postponed for how many years, or what percent of covered obligations will be written off in special cases). The debtor government then has to negotiate implementing agreements with each of the Paris Club members, in which the interest rate on postponed repayments, penalty fees, and precise loans to be affected are determined. These negotiations can drag on for many months after the Paris Club decision and can impose a considerable administrative burden on the debtor government, since it may have to negotiate deals with as many as nineteen individual creditor governments.

The debtor is required by the terms of the Agreed Minute to seek comparable debt relief from all the governments and even the private creditors on which it defaulted. However, creditor governments that are not part of the Paris Club are not bound by the agreement, nor are private creditors, and the debtor government is usually not in a position to press its case. Indeed, even the Paris Club creditors have not succeeded in doing more than exhorting those other creditors to match the relief in the Agreed Minute. As a result, the debtor may receive less relief overall than envisaged in the Paris Club arrangement.

The debtor government is not in a strong position to press its own case in the Paris Club either. Many developing countries that come to the Paris Club (especially the poorer ones) have not had the capacity to estimate their own debt-relief needs. In any case, as noted above, the creditors are mainly guided by the assessment presented by IMF and it has been accused of regularly underestimating the level of needed relief. It is not clear if this reflects an inherent optimism based on the need to assume that the policy and output targets that accompany the IMF's recovery program for the country will be attained, or IMF focus on how much relief the creditors say they are willing to grant. It is only clear that over time the Paris Club has acknowledged the need for deeper cuts in debts owed to its members by the poorest countries and that IMF has produced the economic memoranda needed to underpin those cuts at each step.

[15] Although the Iraqi and Nigerian cases can be claimed as falling under the Evian Approach, the reality is that they were driven by political necessity and not economic analysis.

Multilateral institutions

The IMF was established to mitigate international financial instability. The World Bank and the regional development banks were established to transfer financial resources to selected governments in amounts and on terms that the governments could not get without such assistance. All of these institutions are themselves creditors of developing countries, but given their different nature it is useful to discuss them separately.

International Monetary Fund

The IMF is a credit union. Governments contribute their domestic currencies plus a certain amount of gold or hard currency, and in return are able to draw from the Fund's currency pool during times of need for balance-of-payments adjustment. Of course, the developed countries put very much more into the Fund than the poor countries, as there is no demand to draw the currencies of the latter and all members want to be able to draw the currencies of the former group. This fact provides the argument for "conditionality" in Fund lending: the owners of the drawn resources want assurances that their resources will be returned. It also shapes the governance structure of the Fund. Decision-making power, determined by the voting rules for the Executive Board, is in proportion to the usable resources contributed (although whether that should continue is being contested).

For countries entering a balance-of-payments crisis, IMF is the one international "lender of last resort." It lends when no one else will, albeit not immediately and always with conditions and thus typically after a crisis breaks open.[16] IMF can deploy quite substantial sums of money of its own and it can mobilize large sums from governments on an as-needed basis, especially in any case that is seen to threaten global financial stability. Moreover, once the IMF and the government agree upon an economic adjustment program (by approving a "stand by" or other lending arrangement), other multilateral creditors may step forward and proffer funds. An active IMF program is also a precondition for a Paris Club negotiation. Private creditors in cases of sovereign default have also looked to IMF for leadership on when to negotiate with the debtor government.[17] In short, IMF is regarded as the principal interlocutor of the whole "international community" with the debtor government on its adjustment policies.

All classes of international creditors of a government believe that while balance-of-payments crises—and external debt crises in particular—may occur for any of a variety of reasons, the workout requires policy adjustments by the government. While there may be cases in which this is not true (for example, a crisis caused by a temporary fall in commodity export prices that would resolve itself after prices recovered to a normal level), it is presumed always to be true. IMF thus demands policy changes as the *quid pro quo* for the use of its funds. It also closely monitors the government's policy agreement, releasing its loans only in periodic "tranches" after being satisfied at each point with the pace of implementation of the program.

However, IMF adjustment programs have long been subject to strong criticisms by various international actors, if not by the creditors. The complaints go beyond the fact that IMF imposes stringent constraints on developing economies. The stronger complaint is that the IMF often gives poor advice, demands inappropriate policies in exchange for the funds it provides, and is congenitally overoptimistic about the country's recovery. Indeed, time after time, governments—especially the poorest ones—do not complete their Fund

[16] The phrase "lender of last resort" is used in a different sense here than in discussions of national central banks providing short-term loans to replace liquidity in the commercial banks in a domestic banking crisis.

[17] IMF insists, nevertheless, that it does not and should not intervene in actual debtor/creditor negotiations on the terms of relief. Private creditors agree with the Fund on this, and one of the reasons that they so forcefully resisted the IMF initiative to create the Sovereign Debt Restructuring Mechanism in 2003 is that they feared that IMF would manipulate the debt negotiations from behind the scenes.

programs. The standard defense of IMF policy prescriptions is that the policies would have succeeded if the governments had followed them more assiduously. The reply to that defense is that were governments to have done so, they would have fallen owing to the political disruptions and economic stresses that implementing the programs embodied. Indeed, for over thirty years the IMF has only lent to developing and "transition economies" (Eastern Europe and successor countries of the former Soviet Union), although it was established for all its members to use. Developed countries have not been willing to subject themselves to IMF "conditionality" as it is now being practiced. If IMF programs were such as to be acceptable in developed countries, adjustment programs in developing countries might look somewhat different.

In addition to concerns about the effectiveness of IMF policy advice, many of the poorest countries accumulated so much debt to the IMF while purportedly attempting to follow its advice that they arrived at a debt crisis vis-à-vis the IMF itself. This is especially troublesome because until recently the IMF never countenanced any relief of member obligations to itself. The "preferred creditor" status of the IMF is a conventional practice and not part of the Articles of Agreement of the Fund. Nevertheless, other creditors, including the private sector, accept it. They do so precisely because the Fund serves as the international "lender of last resort." Thus, inability to service IMF debt is a sign of deep financial distress. It means that the country could not service its IMF debt even after receiving all the relief that nonpreferred creditors would accord it.

In fact, the IMF provides some relief from obligations to it of the poorest countries under the international initiative for the HIPCs. It has financed the relief through special operations, in particular using the investment income on the net proceeds from off-market gold sales in 1999.[18] The relief was not, however, enough. Indeed, the governments of the major creditor countries acknowledged this in 2005, and by the end of the year a new Multilateral Debt Relief Initiative (MDRI) had been arranged under which all debts owed to IMF, the World Bank and the African Development Bank (as of end-2004) by specified poor and heavily indebted countries would be cancelled in 2006.

World Bank and regional development banks

The major multilateral development banks were created between the 1940s and 1960s, a period when most governments in the world could not borrow from foreign private sources. Instead, most of the governments joined the World Bank and the regional development banks by purchasing shares denominated in hard currency, with the biggest and richest countries purchasing the largest number of shares.[19] With this strong equity backing mainly from the shareholding of the developed countries, the banks issued their own bonds in the world's largest capital markets at interest rates very close to those of the shareholding developed country governments. The banks have in turn lent these funds for long-term investment projects to developing country members at only a small mark-up over their own interest cost. The lending decisions have been made by the executive boards, whose composition reflects the shareholdings of different governments in each bank, as must have seemed natural to the bankers and finance ministry personnel who created them. Today,

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[18] IMF has a large stock of gold, mainly paid in by members in its early years. The gold is valued on the IMF's books at an artificially low price and so any sale at market prices provides very large capital gains. The constraint on selling the gold is that gold-producing countries fear it will reduce the market price of their gold exports. The 1999 sale was thus artfully designed so the gold never hit the market and it was almost immediately reversed when the buying governments (Brazil and Mexico) used the gold to make loan payments to the Fund, leaving IMF with its original physical volume of gold intact, albeit with some of it now carried on its books at the current market price.

[19] Governments actually had to purchase outright only a fraction of the value of their shares as "paid-in capital," the rest being "callable."

more effective participation of the borrowing governments in decision-making is an accepted goal, although how to achieve it remains in dispute.

Since the poorest countries could not afford loans on the terms resulting from the resources raised from bond sales, the shareholders of the multilateral banks organized highly subsidized lending "windows," most notably the International Development Association (IDA) of the World Bank. These loans were initially funded by contributions from donor governments in proportions and amounts agreed at each triennial refunding exercise,[20] although they are also funded today from repayments of old loans. The loans have a longer tenor than standard World Bank loans (up to forty years instead of twenty) and a service charge of 0.75 percent in lieu of interest (plus a running commitment charge of 0.50 percent to pay before any funds are drawn). A major focus of interest is the extent to which even these loans are too expensive for some countries so that only grant financing is warranted for them. Indeed, IDA is increasingly providing grants instead of loans to the poorest countries.

The difficulty that HIPCs have had in servicing their IMF debt applies equally to their servicing of debts owed to the multilateral development banks. Like the IMF, but for a different reason, these institutions are also regarded as "preferred creditors," and until the start of the HIPC Initiative they had not allowed any rescheduling or postponement of their own obligations. The argument against permitting such rescheduling or postponement is that such a practice would worry the buyers of World Bank and other development bank bonds, since they would view the revenue stream of the bank as potentially compromised by debtors not fully servicing their loans. The bond buyers would then demand a higher interest rate to buy new bonds, and all the borrowers from the development banks would suffer. It was thus arguably in the interest of all the borrowers that each borrower services every dollar of its debt on a timely basis.

The primary flaw in this argument is that the poorest countries borrowed only from the highly concessional windows, which were not funded from bond issues. It is hard to imagine that bondholders would not distinguish Mozambique from Mexico. The second flaw is that when it came time for someone to actually cover the obligations that the poorest countries could not pay to IDA and comparable windows of the regional banks, part of the funds came out of the profits of the banks from their lending to the other countries. This is to say that those somewhat better off developing countries have paid part of the cost of debt relief for the poorest countries (the rest has come from voluntary donations from the richer countries). Thus, insisting that every penny of debt servicing owed to the multilateral institutions be financed, with no outright forgiveness of the obligations of the HIPCs, has at least partly come at the expense of the non-HIPCs.

One way or another, countries qualifying under the HIPC Initiative obtain relief from most of their creditors, and the recent MDRI agreement recognized the need to do more. IMF plays a central role in coordinating this process, as it does for non-HIPCs, although it shares this responsibility more closely with the World Bank in the case of the HIPCs. This is probably because the Bank takes the lead in mobilizing the donors to put up the resources for multilateral debt relief (and that the initiative was started by its former president). But it is probably also because unlike debt relief for other countries, relief under the HIPC program requires that the government develop in consultation with its civil society a package of structural reforms and pro-poor policies that it incorporates into a Poverty Reduction Strategy Paper (PRSP).[21] Debt relief for HIPCs, in other words, is conditioned on the adoption of an agreed set of social policies, in addition to the standard economic policies demanded of other debtor governments.

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[20] IDA completed its fourteenth replenishment in 2005.

[21] In fact, many governments have prepared PRSPs with limited consultation and in some cases World Bank staff themselves prepared PRSP drafts on an interim basis. While some fault the Bank for not pushing hard enough for civil society involvement (or for not taking challenging civil society views on board when expressed), the PRSP exercise seems a unique foreign intervention into borrowing country politics.

DO THE PIECES COHERE AS A FAIR GAME?

Although the present arrangements for HIPCs and other countries clearly concentrate power on the side of the creditors, it should be noted that they are actually less unbalanced than the case of private corporate bankruptcy proceedings, where creditors hold almost all of the power over the disposition of the bankrupt enterprise. Defaulting on obligations to creditors is considered a serious breach of property rights, which are considered an essential aspect of a well-functioning market economy.

A question that is central to recent debates on sovereign debt is whether the treatment of sovereign governments in debt crisis should be modeled on US bankruptcy laws, which embody an option to allow the bankrupt entity a "fresh start." However, the proposal is not to model sovereign bankruptcy on the U.S. treatment of bankrupt corporations, in which power is very heavily concentrated in the creditors, as noted, but rather in the treatment of municipalities facing bankruptcy. When municipalities and other sub-sovereign public entities in the United States go bankrupt, a separate part of the U.S. bankruptcy code (chapter 9) is applied. Some have suggested that the model ought to be adopted to deal with sovereign insolvency too, since it seems more even-handed in its treatment of creditors and debtors. However, sub-sovereign public entities within the United States are responsible to the states. At present, there is no comparable responsible authority at global level over sovereign governments, nor is there a comparable legal system or enforcement mechanism. Strictly speaking, then, chapter 9 is an inapplicable model, though the question remains of whether arrangements that share some of its features would improve on the present process for resolving sovereign debt crises.

Instead of a bankruptcy regime, the "international community," as represented by the IMF and World Bank, plays something like the role of central overseer/umpire, most explicitly as concerns the HIPC debt workouts. The Fund and Bank Executive Boards, which include developing countries—if only with a minority voice—as well as developed countries, can be said to coordinate the official creditors, who account for almost all of the debt, as such poor countries usually have only limited amounts of defaulted private debt. Yet, many people believe the process has not worked well. The relief accorded has been halting and inadequate. It is given in stages, like the tranches of IMF adjustment financing, albeit over a longer period of time. And when the final arrangement is agreed and the relief becomes "irrevocable," only some of the creditors cancel the obligations straightforwardly; others commit to cover the debt servicing as it falls due year in and year out for decades to come, as necessary, which is less assured.

Not surprisingly, there have been many strong criticisms of the HIPC process, not least that it has not been successful in bringing about sufficient debt relief to enable HIPCs to enter onto sustainable development paths. The HIPC initiative will be ten years old in 2006, and as of end-2005, only 18 of 38 countries that have been targeted as beneficiaries had reached the "completion point" in the process. Moreover, as noted above, even that amount of relief was considered insufficient, and is to be supplemented with the MDRI. But then after the "final" completion point, the multilateral institutions and government donors will again offer new loans to the borrowers and perhaps begin a new cycle of debt buildup leading to debt forgiveness. The alternative would be to provide more assistance in the form of grants, but the major creditor governments also do not seem willing to increase the level of grant assistance adequately to replace future unsustainable borrowing. Moreover, one could say that the entire mindset in which the HIPC initiative operated has been wrong. It is as if the relief was a reward for adhering to an adjustment program rather than acknowledgement that the country was insolvent and its obligations unpayable.

In the case of non-HIPCs in debt difficulty, international coordination of the debt workout has been elusive. There is a mixture of private and official creditors (multilaterals do not offer relief in these cases) and no joint mechanism by which the necessary overall amount of relief can be assessed and apportioned. Each class of creditors seeks the best deal it can get when a restructuring is necessary: commercial banks through a London Club, bondholders through various bondholder committees, government creditors through the Paris Club, and others independently. There is no coherence mechanism to put the pieces together and see if they add up to what the country needs. There is also no interest among the major creditor governments, organizations of private creditors, or major international borrowing governments to consider what such a coherence mechanism might look like. It is not because any of these parties think the current situation is ideal. They rather fear that anything else would be worse for them.

And that seems to be the state of the sovereign debt game today.