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Statutory Sovereign Debt Workout Mechanisms: Why and How?*

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Because of the absence of a multilaterally agreed legal system for debt workouts, the practice tends to be ad hoc and disorderly, generally favouring creditors. Often the IMF is involved in coordinating and resolving debt servicing difficulties, be it due to solvency or liquidity problems, based on an adjustment programme agreed with the debtor country. The Fund generally seeks a voluntary agreement with creditors, but its position is asymmetrical – while it has a significant leverage vis-à-vis sovereign debtors it cannot impose appropriate terms and conditions on creditors. Such ad hoc restructuring has rarely secured sustainability where there were problems of solvency. In cases where debt servicing difficulties were due to liquidity shortages, it provided relief through maturity rollover at penalty rates, but this often came very late in the crisis and failed to prevent the damage in terms of substantial costs in lost jobs and incomes.

It has been argued, mainly by actors in the international financial markets that statutory debt restructuring mechanisms would be counterproductive and the task could be done equally by voluntary and concerted mechanisms, notably by means of the so-called Collective Action Clauses (CACs) in bond contracts, including clauses for collective representation, majority action and sharing, and automatic rollover provisions in contracts for bank credits.

Such provisions in debt contracts can no doubt help address a number of issues such as collective action problem and creditor holdouts and facilitate renegotiations. However, wider dispersion of creditors and the existence of increased variety of debt contracts associated with the growing integration and spread of international financial markets make it highly uncertain to rely on such mechanisms alone for a rapid resolution of debt crises so as to contain their damage.

CACs and automatic rollover provisions cannot prevent currency and balance-of- payments crises which are almost always associated with debt crises in developing countries (DCs), resolve conflicts among different classes of creditors or secure efficient, orderly and fair resolution of debt crises.

Experience shows that as soon as a country starts experiencing difficulties in meeting its external debt servicing obligations, it gets cut off from new sources of finance, even trade credits, and faces capital outflows. The risk of debt servicing difficulties triggering capital outflows is now greatly enhanced because of increased liberalization of the capital account in DCs.

Under these conditions it is extremely difficult to reach to all creditors to activate the safeguard mechanisms and provisions incorporated in debt contracts so as to come to a quick resolution of debt servicing difficulties and their spillovers to the balance-of-payments and the real economy. As the UNCTAD Secretariat Note points out, under current arrangements it can take several years to resolve debt crises. During such a time, the debtor finds itself in distress, incur large losses of income and employment as its access to external financing is impaired and its reserves are drained by capital flight.

There can be little doubt that multilateral lending can bring considerable relief to debtors and the IMF has established various facilities to help countries falling in debt servicing difficulties. However, such lending often seeks to impose pro-cyclical conditionality in an effort to restore confidence among creditors and secure debt sustainability.

Quite apart from conditionality, multilateral lending to countries in debt distress faces a number of other problems. First, such lending is often designed to keep debtors current on their obligations to private creditors and maintain an open capital account, rather than financing imports essential to

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maintain income, investment and employment. It thus creates creditor moral hazard without alleviating the difficulties faced by the debtor.

Second, it is not always clear when a crisis is a solvency crisis or a liquidity crisis. Liquidity crises can become solvency crises in the absence of adequate provision of external financing. But lending into arrears to private sector could also threaten IMF financial integrity because the Fund enjoys no *de jure* preferred creditor status, particularly when the amounts involved are large. Indeed at least on two important occasions, in Russia and Argentina, IMF programmes could not prevent default. In this respect large scale lending by the IMF to the eurozone (EZ) should be a cause for concern. In fact there is no justification for the EZ to draw on the IMF since unlike DCs the EZ can issue unlimited international liquidity and the moral hazard argument used against intra-EZ bailouts also applies to IMF bailouts. By lending to the IMF to lend to the EZ periphery rather than lending to the periphery directly, the EZ is effectively shifting the default risk to IMF shareholders, including its poor members.

The recognition of such problems has led to various proposals to involve the private sector in the resolution of the sovereign debt crisis. As the UNCTAD Secretariat Note points out, one particular proposal is to establish a statutory sovereign debt restructuring mechanism by drawing on three key principles of Chapter 11 of the US bankruptcy law:

- Temporary standstills on external debt, whether debt servicing difficulties are due to solvency or liquidity problems – that is, whether debt would eventually have to be reduced or rolled over. The decision for a standstill should be taken unilaterally by the debtor country and sanctioned by an independent panel rather than by the IMF because the countries affected are among the shareholders of the Fund which is itself a creditor. This sanction would provide an automatic stay on creditor litigation. Such a procedure would be similar to WTO safeguard provisions allowing countries to take emergency actions to suspend their obligations when faced with balance-of-payments difficulties. Standstills would need to be accompanied by exchange controls to stem capital flight.

- Automatically granting seniority status to debt contracted after the imposition of the standstill -- the so-called debtor-in-possession financing in the US law. The Fund could play a key role in lending into arrears, but this should be designed to finance trade not debt payments or capital outflows. Thus, it is important that the Fund lending at times of large and continuous outflows of capital should be accompanied by temporary standstills and exchange controls to secure private creditor involvement.

- Debt restructuring including rollovers and write-offs, based on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and CACs in debt contracts – thus, combination of voluntary and statutory mechanisms. However, there would be a need for arbitration in the event that the debtor and creditors fail to reach agreement.

The Fund appeared to be moving in this direction at the end of the last decade with growing difficulties and risks of moral hazard in financial bailout operations and the increased frequency of crises in emerging markets. The IMF Board recognized that countries facing debt servicing difficulties should first seek voluntary agreement with the creditors on temporary standstills. However, it agreed that "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally." Furthermore, the IMF Board recognized that since "there could be a risk that this action would trigger capital outflows … a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls."

The Board was also willing to provide support to countries imposing standstills and restrictions by "signalling the Fund's acceptance of a standstill … through a decision … to lend into arrears to private creditors."

The Fund secretariat moved towards establishing a formal mechanism along these lines. Its Chief Economist, Ann Krueger, argued that such a mechanism should "allow a country to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling with its creditors, given the Fund's consent to that line of attack. During this limited period, probably some months in duration, the country would have to provide assurances to its creditors that money was not fleeing the country, which would presumably mean the imposition of exchange controls for a temporary period of time."

The Fund secretariat prepared a proposal for Sovereign Debt Restructuring Mechanism (SDRM). However, even though statutory protection to debtors in the form of a stay on litigation was excluded and considerable leverage was given to creditors in granting seniority to new debt because of pressures from financial markets and some major advanced economies (AEs), the proposal could not elicit adequate political support. It was first placed on a backburner and then abandoned.

The impetus for reform has generally been lost since the turn of the millennium because of widespread complacency associated with the recovery of capital flows to DCs and their improved payment and reserve positions and debt profiles. However, this complacency regarding the resilience of DCs to shocks and crises is misplaced. Even the IMF now recognizes that an important reason for the strong economic performance of DCs in the new millennium is due to exceptional global economic conditions driven by unsustainable policies in AEs, including consumption and property bubbles, historically low interest rates and rapid expansion of international liquidity.

Already the spending booms in AEs have come to an end. Historically low interest rates and rapid liquidity expansion in AEs are certainly not there to stay forever. The collapse of Lehman Brothers shows us how quickly capital flows to DCs can come to an end as a result of an event that has little to do with them and why the EZ crisis can present a serious threat to their financial stability. There is indeed a growing concern that crisis may move to DCs after spreading from the US to Europe. Once again, the international community could be caught unprepared, pushed into messy ad hoc operations to address problems of debt distress and instability in several DCs.

For these reasons the UNGA initiative to bring back the issue of resolution of sovereign debt to the centre of multilateral debate is highly commendable.

Perhaps we should also discuss in this context not only commercial but also official sovereign debt. Existing procedures for official debt workouts also need a fundamental change. Decisions on restructuring such debt are currently left to a club of creditors – the Paris Club – and tied to IMF structural adjustment programmes and sustainability assessments. Sustainability is often judged on the basis of how much debt and debt servicing a country can tolerate without adequate attention to its implications for development and poverty, and the attainment of multilaterally agreed goals. Furthermore, political considerations often dominate debt-relief outcomes. It might be highly desirable to delink official debt restructuring from the IMF, and leave debt sustainability analysis to an independent body of experts, appointed with the consent of the debtors. The BWIs and the United Nations agencies could provide inputs to this process in their respective areas of work. Debtor countries should also be allowed to submit their own analyses of sustainability. Consideration should also be given to establishing impartial arbitration for official debt disputes along the lines of Chapter 9 of the US Bankruptcy Code which deals with public debtors and applies the same principles as Chapter 11.

The question of whether sovereign domestic debt should also be covered by the SDRM was discussed during the debate on the proposal. It was excluded on grounds that governments typically had at their disposal tools for restructuring domestic debt. However, it was recognized that domestic debt restructuring could be called for overall sustainability, secure inter-creditor equity and improve the willingness of international creditors to agree to adequate debt reduction. This issue has gained added importance because of greater openness of domestic debt markets in DCs to non-residents and growing acquisition of domestically-issued sovereign debt by them. Thus it needs greater attention in the design of a statutory sovereign debt restructuring mechanism.

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