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Sovereign Debt Crises and Multilateral Action Following the Rejection of the Krueger Proposal

The principle of restructuring sovereign bond issues via an appeal to collective action clauses, in a contractual manner, seems likely to become general usage. This follows the rejection of the International Monetary Fund's proposal to create a "bankruptcy law for sovereign debtors". Such clauses are both flexible and not very restrictive. But they do not settle the major issues involved in crisis management: i.e. coordination among the bearers of public debt, the relationship between such claims and the IMF, the link between financial negotiation and economic policy commitments by the country in question. These issues will inevitably surface with respect to the question of unilateral moratoria on foreign debt and the control of capital outflows. Such unilateral decisions will continue to raise strategic questions for the IMF: Can multilateral rules define the conditions in which the public authorities are permitted to intervene in private contracts established in global capital markets?

At the meeting of the main shareholders of the World Bank and the International Monetary Fund in April 2003, it was decided to abandon the proposal for a "bankruptcy law for sovereign debtors". The proposal was launched at the end of 2001, by the management of the IMF, and especially by its First Deputy Managing Director Anne Krueger. Extensive preparations followed, which did not, however, disarm the proposal's main critics: the private financial sector, several emerging countries including Brazil and Mexico, and finally, after much hesitation, the US government. This is therefore a serious setback for the IMF, which comes after of the Contingent Credit Line. This was another innovation adopted in 1999, which codified the strategies followed during the preceding years, but which was not subsequently implemented. The debate on the so-called "new international financial architecture" thus finds itself in an impasse, which underlines again the poor progress made since the Asian crisis.

The IMF Proposal

The IMF's proposal was based on a widely-shared observation: the disintermediation of capital flows to emerging economies since the early 1990s makes it very difficult to restructure sovereign debt. More specifically, it is no longer possible to employ the method used in the 1980s, which was based on formalised interaction between the IMF, the defaulting country and the various classes of creditors: the Paris Club which brings together public lenders and the London Club which represent the commercial banks [1]. Nowadays, the diversity of investors, the highly varied incentives and constraints they face and the variety of legal forms of debt contracts are all obstacles to defining new rules for collective action to deal with sovereign defaults.

Yet such defaults occur repeatedly and they generate systemic risks par excellence, in as much as they test markets' capacity to absorb and to survive crises. The absolute counter-example is still that of the 1930s, when, in a specific international context, and given the absence of a negotiating structure, numerous countries repudiated their debts, so that private capital flows to developing economies dried up for 40 years [2]. For this reason the debate which has just been concluded may have significant consequences. It is about a public good that is both precious and fragile.

To meet the new problems which emerged in the 1990s, the IMF proposed a radical solution in the form of the *Sovereign Debt Restructuring Mechanism* (SDRM) [3]. A specialised Sovereign Debt Dispute Resolution Forum was to be created, housed at the IMF, but with statutory autonomy. Its goal was to have been to

1. W.R. Cline (1995), *International Debt Reexamined*, Institute for International Economics, Washington.
2. H. James (2001), *The End of Globalisation, Lessons from the Great Depression*, Cambridge, Harvard University Press.
3. See the final proposal: IMF (2003), "Proposed Features of a Sovereign Debt Restructuring Mechanism", prepared by the Legal and Policy Development Review Department, 12 February. For a review of the various critiques and counter-proposals which helped generate debate see M. Miller (2002), "Sovereign Debt Restructuring: New Articles, New Contracts - or No Change?", *International Economics Policy Brief* PB02-3, International Institute of Economics, April.

insure coordination between defaulting countries and the many bearers of bonds. This negotiating framework, which in principle would have been predictable, reliable and rapid would have addressed risks of strategic gridlock, as well as hostage-taking and unilateral action during negotiations. To this end, the Forum was to have the legal powers to impose decisions reached by a qualified majority (75%) of debt holders on minority investors, relating for example to reducing outstanding debts. Hence the comparison with a "bankruptcy judge", who would have validated a majority decision through a legal ruling – in other words a legal act that is more binding than a private contract.

This mechanism was based on two principles, which generated most resistance. First, the SDRM implied public intervention in private contracts. This was refused by the private finance sector, especially as it was proposed by the IMF[4]. Second, the legal authority bestowed on the Forum would necessarily have given new, marked supranational capacities: the Forum could have blocked appeals by minority investors in New York or London courts, aimed at defending their initial contractual rights. Other things being equal, this would have created a body similar to the International Criminal Court, whose rulings are not limited by guarantees that each signatory state offers its nationals. The new mechanism would therefore have largely gone beyond classical multilateralism, based on the cooperation between sovereign parties.

Collective Action Clauses

Where does the debate on sovereign debt stand after the abandonment of the SDRM proposal? Has the debate on managing payments crises gone back to square one? In fact, the private financial sector and several emerging countries have made one key step forward: they have admitted, perhaps faced with the threat of the SDRM, that pure improvisation in dealing with sovereign defaults may indeed be dangerous. They have thus moved towards the idea of supporting a contingent rule for debt re-negotiation, though refusing to provide it with the "statutory" or quasi-judicial form which characterised the SDRM. These rules take the form of *Collective Action Clauses* (CACs), which have long been used in the London markets, but which so far have been alien to working practices on Wall Street[5]. CACs are also a form of coordination rules based on qualified majority voting (for example 70% or 80%), but in this case they are entirely written into the terms of initial debt contracts. That explains why CACs are "voluntary", in other words approved *ex ante* by private investors, as opposed to the SDRM whereby a third party, with strong powers, would have been brought in *ex post*.

The CACs main advantage lies in their institutional lightness. They fit into the usual practices of the financial markets, which, when dealing with defaults, frequently resort to out-of-court settlements or arbitrage procedures that lie on the edges of legal institutions and "in the shadow of the law"[6]. Supporters of this approach have stressed its advantages over strong rules as with the SDRM: the history of company bankruptcies, in the United States, France and Britain, indicates that agents, when faced with dysfunctional institutions or excessive constraints, tend to circumvent legal rules, which in turn creates greater market distortions and risks.

Three levels of analysis need to be distinguished in order to identify the drawbacks and hence the risks stemming from CACs. The first has generally been the only one to figure in recent debates, though with some rare exceptions. It relates to the problems of collection action among bondholders. In this case, the relative lightness of CACs entails limits: they only solve the problems of coordination for bearers of one type of bond issue. As a result, dealing with the overall stock of international bonds not covered by CACs remains open. There is above all an on-going problem of coordination between issues, in other words the persistence of separate contractual structures which would have been dealt with jointly by the Forum, in a way similar to that used by company liquidators who force creditors into collective negotiations[7]. At this point, it becomes difficult to reach a clear-cut conclusion in the debate on the respective merits of contractual and statutory approaches. Would a conciliatory approach and a common interest in obtaining a constructive solution be enough? Only time and experience will provide an unambiguous answer to this. Indeed, the main difficulties lie outside this limited framework.

The second problem relates to the other forms of public debt which may lead to a financial crisis, and which CACs do not cover at all. On the contrary, the discussion on SDRM, which first looked at the coordination between bond issues, was rapidly expanded to include international bank credits, and then debt owed to the Paris Club. The problem of internal public debt came up lastly, and inevitably [8]. Thus, an explicit rule or incentives created along the lines of SDRM would have lead initial actors in negotiations to coordinate their actions more directly with other concerned creditors, so as to resolve crises. Given

4. The IMF sought to provide numerous guarantees on this issue, following criticisms of Anne Krueger's text. Similar doubts were also expressed by ONGs, which were otherwise in favour of a legal-type approach. See for example, Jesuits for Debt Relief and Development (1999), "The case for an International Insolvency Court", Washington, September.
5. See EMTA (2002), "EMTA Proposition Regarding the Quest for More Orderly Sovereign Work-Outs", October (www.emta.org).
6. See P. Brierley & G. Vlieghe (1999), "Corporate Workouts, the London Approach and Financial Stability", *Financial Stability Review,* 7 November.
7. See *La Lettre du CEPII*, "The Ecuadorian Crisis and the International Financial Architecture", March 2000, <www.cepii.fr>.
8. See especially the IMF (2002), "Sovereign Debt Restructuring Mechanism - Further Considerations", prepared by the International Capital Markets, Legal and Policy Development Review Departments, 14 August.

their comprehensive nature, such agreements would have met the criterion of economic efficiency (the stabilisation of the country in crisis and of the markets) and the criterion of equity (sharing the sacrifices between the country and various creditors)[9]. As the perimeter of collective action is extended, so the contents of the common good would have risen.

Ultimately, this is the logic which shapes bankruptcy proceedings: by superseding contractual rights, with agents looking for individual solutions to crises (typically the case of runs on banks), such an institution modifies the rules of the game and supports the convergence interests of all parties (investors, international banks, holders of local treasury bonds, public creditors etc.). By definition, this cannot be done with a contingent rule of a contractual nature, which is bounded by the frontier of the initial contract.

Private Re-negotiation and Conditionality

The third level of analysis concerns the issue of public intervention in a crisis. This raises a problem much discussed by politicians and policy-makers, a problem which remains unclear, however, from an analytical point of view, namely that of the conditionality of the IMF. More specifically, the manner in which the difficult relationship between the Fund and the country in crisis functions is vital to the credibility of commitments made reciprocally, by both parties [10]. In the classical model of the 1980s – which was slow but functional – an agreement with the IMF provided countries with a "seal of approval" that conditioned their financial agreements with creditors. Without such approval, a country would not be able to return to the markets. Conversely, after the signing of a formal agreement with the IMF, multilateral loan disbursement was conditional on an agreement being reached with the banks[11]. As a result, a strong bond linked the re-negotiation of sovereign debt with the interaction between the crisis country and the IMF, giving the latter a formidable lever.

Nowadays, however, conditionality is weak. Not only is the capacity to coordinate creditors problematic, but the linkage to IMF intervention is not very structured. Commitments made to the Fund are therefore far less important than during the 1980s, because they no longer directly determine renewed access to capital markets: "burden sharing" is no longer directly linked to conditionality. Consequently, stabilisation programmes are intrinsically more fragile and the Fund can only rely on multilateral loans and the threat of their suspension to ensure that commitments are respected. Countries are therefore far more tempted to play "cat and mouse" with the Fund, by avoiding conditions, re-negotiating agreements, or massaging statistics. Symmetrically, the Fund may seek to compensate its greater weakness by obtaining longer series of structural commitments. The experience of the Asian crisis, however, shows that once market pressures fall off, both the IMF and its programmes may see their legitimacy challenged even when they are not completely pushed aside.

Should it therefore be concluded that multilateral action no longer has the means to regulate capital markets strongly and to negotiate stabilisation programmes credibly? Will the "new financial architecture" forever be based on weak conditionality now that the principle of formulating a law on sovereign bankruptcy has been put aside? In fact, the problems raised by the SDRM are likely to reappear sooner or later, in ways that are more familiar than they may first appear: i.e. as unilateral moratoria on foreign debt and above all as temporary exchange controls on capital outflows, as an instrument to manage liquidity crises [12].

Multilateral Action and the Interventionin Private

During the Asian Crisis, the IMF's guiding principle was to guarantee the free exit of capital via its intervention as a lender-of-last-resort, whereas capital controls were held up as a deadly sin. Since the crisis, this issue has been addressed in a different manner, following the numerous criticisms levelled at such intervention. Given that there is a limit to the multilateral resources which can be mobilised to support any one country, restricting market mechanisms (i.e. putting limits to capital outflows) becomes inevitable and the aims of policy must be to generate as little instability as possible, within this constraint.

The first proposal on a sovereign bankruptcy law, put forward in November 2001, was based on this observation. It included the principle of an automatic stay on sovereign debt, and the possibility of imposing exchange controls on capital outflows if necessary. Some have regretted that the proposal then put these measures to the approval of investors. But this had the advantage, which is not negligible, of at least subjecting the decision to block capital flows to negotiation. This made it all the more open to debate, given that it was approved by all participants in bankruptcy proceedings. Lastly, any decision to block capital flows would have been confirmed by a "proto-judicial" body – the Forum – which would ostensibly have been

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9. A proposal was also made to create different classes of creditors within the SDRM, classes that would be subject to qualified majority voting, and for which accepting a debt plan would have been subject to collective agreement: each class would then have had the power to veto the outcome of the negotiations.

10. This article is only concerned with macroeconomic conditionality, and not the conditionality which development banks may impose.

11. See J. Sgard (2002), *L'Economie de la Panique, faire face aux crisis financières*, Paris, La Découverte (chapter 8), for the various linkages between re-negotiation and conditionality.

12. See notably M. Miller & L. Zhang (2000), "Sovereign Liquidity Crisis: the Strategic Case for a Payment Standstill", *Economic Journal*, No 100.

depoliticised, providing investors with numerous guarantees (prevention of risks of theft etc.). To sum up, SDRM actors could have acted jointly to extend the principle of suspending payments of public debt to all, or a large share of the balance of payments.

The unilateral control of capital outflows, as occurred in Malaysia in 1998, had a comparable effect. It too implies an *ex post* intervention in payments flows, in other words in the contractual commitments by residents to the rest of the world. The shock for private operators was thus comparable, as was the justification for managing the crisis: i.e. the interest of protecting a common good against a full-blown market crisis.

Differences, which again are not negligible, lie in the *modus operandi*. The SDRM would have defined and supervised collective action, intervening directly in contracts and leading to re-negotiation procedures. This would have been an opposing approach to unilateral and administrative controls, which are a much rougher manner of "exiting the market". It upsets foreign trade and financial links, without providing any guarantees about the way public authorities may use their new room for manœuvre. Consequently, such measures always tend to be highly contested and destabilising, though the failure of the SDRM suggests that they will reoccur in the future. Indeed, failing the existence of an *ad hoc* multilateral framework, many countries will likely prefer opting-out of the markets than be exposed to the risks of a destructive crisis, as in Indonesia, where the international institutions showed themselves to be little effective. Having failed to put together a global instrument for managing payments crises – lender-of-last-resort or a bankruptcy law – the IMF may thus find itself threatened by "fragmentation from below", as member states may reject multilateral action and adopt unilateral defences against crises and contagion. Only a framework of *ex post* agreements with the IMF, supporting temporary exchange controls on capital outflows, would preserve the multilateral approach to managing crises. As a counterpart to multilateral approval, such agreements would need to specify the terms of controls and supervise the actions of the national, public authorities, as long as contracts would be restricted. Their approach would, however, be formally less effective than the SDRM[13].

The Continuation of the IMF's Crisis

With the scrapping of the SDRM, exchange controls on capital outflows as an ultimate policy instrument raises a major issue for the IMF and its main shareholders. As the Fund is not involved in deciding such controls, as it would have been with the SDRM, does it have a role in validating such public intervention in private contracts? The refusal to grant the Forum legal authority to launch bankruptcy proceedings may certainly justify, in the future, a refusal to let the Fund endorse capital controls, which also interrupt contractual obligations. Yet this doctrinal issue cannot be avoided forever. It exists in laws regulating national financial systems, and it is increasingly present internationally, given the expansion of private, global financial markets.

Failing a precise answer to these problems by the IMF and its shareholders, new crises may continue to be met via a *deus ex machina*, such as an international lender-of-last-resort, with all its known risks. Alternatively, countries could be left to their own devises, when confronted with a systemic crisis, before contacts may be re-established several months later, as happened with Argentina at the end of 2001. Crisis management will thus depend on the public and private interests of the moment, on the international context and policy improvisation. The Fund may thus work well for Brazil and terribly for Argentina; it may also walk the tight-rope in Turkey or be manipulated by local politicians, as in Russia. In this case, the principles of multilateral action – the IMF and conditionality – and more generally the public good, will lose out.

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13. On this point see, in particular, A. Haldane & M. Kruger (2001), "The Resolution of International Financial Crises: Private Finance and Public Funds", Bank of Canada and Bank of England.

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