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Resolving Sovereign Debt: Collective Action Clauses or the Sovereign Debt Restructuring Mechanism

Shalendra D. SHARMA*

When sovereign debt restructuring or debt reduction becomes unavoidable, what is the appropriate regime that can provide for an orderly restructuring, while at the same time protecting the rights of both creditors and the debtor? The recent wave of sovereign default has underscored the limits of the current market-based regime. Recently two alternative approaches propose a “contractual approach” by way of the introduction of collective action clauses (CAC) in bond contracts, and a “statutory approach” put forward by the International Monetary Fund (IMF), which calls for the establishment of an international debt restructuring mechanism (called the sovereign debt restructuring mechanism or SDRM) that would have many of the features of an international bankruptcy regime. This paper assesses the two crisis-resolution mechanisms. It shows that although no consensus exists on whether the best approach about how to manage and resolve sovereign debt crises is to promote the use of collective action clauses, or to create a statutory mechanism, it is, nevertheless, evident that the SDRM is shelved for the time being.

It examines the reasons for this, and argues that to the contrary, a complementary approach that combines elements of both the CAC and the SDRM (now proposed by the IMF) has the potential to help reduce the unacceptably large costs associated with disorderly defaults by sovereign governments whose debt burdens have become unsustainable.

I. INTRODUCTION

When countries run up unsustainable debt burdens and have no feasible macroeconomic policy options to resolve the problem, they must seek a restructuring of their obligations. However, in the international financial system there is no established framework for the predictable and orderly restructuring of sovereign debts, nor a comprehensive mechanism for private creditor majority decision-making. This problem is compounded when the debt is comprised of numerous debt instruments and issued in different jurisdictions. Under such circumstances, as a sovereign debt crisis unfolds, many creditors “rush to the exits” as they try to liquidate their claims at the same time, causing a crisis with painful (and

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usually avoidable) costs for both the creditors and the debtor country. In the face of destructive economic meltdown and often disorderly and protracted debt restructuring, the IMF and the G-7 are forced to step in with huge bailout packages.

As debt-restructuring negotiations under the arrangements of both the Paris Club (which deals with debt owed to official-sector creditors) and the London Club (which deals with debt owed to private sector creditors) have been protracted and divisive, over the years there have been several discussions regarding the creation of a more effective institutional framework to deal with sovereign debt.¹ Proposals have ranged from calls for an international bankruptcy court to market-based debt buybacks. In the late 1980s, the Brady plan recognized the legitimacy of international debt reduction and brought about a real reduction in the debt that some countries owed to commercial banks. Following the 1994–1995 Mexican peso crisis, Jeffrey Sachs proposed an international bankruptcy regime modelled on Chapter 11 of the US bankruptcy code which would give insolvent countries the same protection from creditors as insolvent private firms,² while Eichengreen and Portes proposed a combination of contractual and institutional changes, claiming that such an approach would not require an international bankruptcy court.³ However, a series of devastating financial crises beginning with the Asian meltdown in 1997 and culminating in Argentina's unprecedented default in 2001 renewed the debate about how best to prevent crises and resolve the resultant debt workout problems. Indeed, as it became clear that the Argentine crisis was made worse as a result of the deadlock caused by its default, observers (especially at the IMF), became more convinced that Argentina's problem could have been mitigated had a formal debt restructuring system been available.⁴

II. THE KRUEGER PROPOSAL

It is in this context, that on 26 November 2001, Anne Krueger the first deputy managing director of the International Monetary Fund (IMF) made a bold policy proposal regarding how to facilitate workouts of distressed sovereign debts.⁵ She observed that, "we lack incentives ... to help countries with unsustainable debts resolve them

¹ In fact, the rescheduling of official bilateral debt in low-income countries through the Paris Club produced little long-term relief. Instead, it led to a rapid build-up of debt because of the accumulation of interest on rescheduled claims.

² Chapter 11 allows companies to continue operating and to repay creditors' claims from future earnings rather than from the proceeds of liquidating their assets. This is made possible because there is a stay on litigation against the company that was initiated before bankruptcy filing and on litigation after the filing. Companies may obtain new loans (i.e. debtor-in-possession financing) that are senior to all claims that existed before the filing.

³ Jeffrey Sachs, "Do we need an International Lender of Last Resort?" Graham Lecture, Princeton University, 1995. Barry Eichengreen and Robert Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (London: Centre for Economic Policy Research, 1995).

⁴ Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington, D.C.: Institute for International Economics, 2002).

⁵ See "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring". Address by Anne Krueger, First Deputy Managing Director, International Monetary Fund, given at the National Economists Club Annual Members' Dinner American Enterprise Institute, Washington, D.C. 26 November 2001.

promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors. It is high time this hole was filled.”⁶ To fill this hole, Krueger announced that the IMF was considering establishing a universal statutory framework that would create a legal framework for collective decision-making by debtors and a supermajority of creditors. Such a framework, Krueger noted, was urgently needed because domestic bankruptcy law (while a useful model in the insolvency context), has only limited applicability given the unique characteristics of a sovereign state. Moreover, the existing approach to crisis resolution which relies on large bailouts creates a moral hazard and undermines long-term financial stability because the international system lacks an effective legal framework for the predictable and orderly restructuring of sovereign debt. Indeed, Krueger’s proposal was an implicit acknowledgement that the way the IMF and other multilateral financial institutions deal with financial crises needed a fundamental overhaul.

Krueger argued that the Fund’s proposed “Sovereign Debt Restructuring Mechanism” (SDRM), based on five key principles would provide for prompt, orderly and predictable restructuring of unsustainable debt. Specifically, under the SDRM the sovereign debtor would, if needed, have protection from disruptive legal action by creditors during negotiations. This could be provided, in appropriate circumstances, through a stay on litigation and preventing creditors from seeking court decisions for repayment while negotiations were under way. Second, creditors would be provided with assurance that debtors will negotiate in good faith and will pursue policies designed to protect the value of creditor claims. Third, creditors would be permitted to protect and prioritize new private lending during the restructuring process in order to facilitate ongoing economic activity through the continued provision of, *inter alia*, trade credits (similar to Chapter 11 debtor-in-possession financing⁷). Fourth, a supermajority of creditors could vote to accept new terms under a restructuring agreement. If new terms were adopted, minority creditors would be prevented from blocking such agreements or enforcing the terms of the original debt contracts. And, fifth, a dispute-resolution forum would be established to verify the claims of different parties to the negotiation. This forum would assure the integrity of the voting process, and adjudicate disputes that might arise.

⁶ Krueger, *ibid.*, p. 1.

⁷ Up to the mid-1970s, bankruptcy provisions were largely biased in favour of creditors. That is, a bankruptcy petition could be filed either by the debtor or creditor, requesting a court of law to declare that an individual or company was insolvent and could not meet its debt service commitments. The court then appointed a receiver to investigate whether a debtor was indeed insolvent, and if the receiver considered it necessary, they could call a meeting of creditors to find out whether they wished to declare the debtor bankrupt. If so, the company would enter liquidation—its assets sold and the proceeds distributed as per specified norms among the creditors and shareholders. In the United States, under Chapter 11 of the Bankruptcy Reform Act of 1978, an effort was made to redress the obvious bias in favour of creditors. As noted earlier, Chapter 11 allows a firm to apply to a court of law for protection from its creditors while it undertakes restructuring to pay off its debts. Similarly, in the United Kingdom, under the Insolvency Act 1985 and 1986, firms can be placed under administration rather than liquidation with the affairs of insolvent debtors being the responsibility of a registered insolvency practitioner. Thus Chapter 11 and insolvency provisions in the United States and the United Kingdom are laws that provide for an intermediate step between financial distress and liquidation and thus seek to provide some degree of protection to debtors.

Arguably, the SDRM is one of the more “radical” proposals the IMF has made. If implemented, it would enable a sovereign debtor and a supermajority of its creditors to reach an agreement binding all creditors for all the debt of the sovereign while respecting the seniority of claims. Further, it provides a mechanism which, when activated, would enable creditors and debtors to negotiate a restructuring, aggregating across instruments, and ratifying an agreement binding on all by a specified supermajority. As with a domestic insolvency law, the SDRM would aggregate claims for voting purposes and could apply to all existing claims. An independent and centralized dispute resolution forum would be established to verify claims, insure the integrity of the voting process, and adjudicate disputes that might arise. Thus, the SDRM effectively would provide a legal basis for decisions by a debtor and a qualified majority to be made binding on all creditors. Perhaps, more controversially, the SDRM would under certain conditions allow a government’s international debt repayments to be temporarily suspended while negotiations were taking place on restructuring the debt. As Krueger aptly noted, the establishment of an effective SDRM would not only fill a glaring weakness in the emerging international financial architecture by ensuring the timely and orderly restructuring of unsustainable sovereign debts, but also put debtors and creditors rather than the IMF in the driver’s seat regarding debt negotiations.

III. REACTION AND THE REVISED KRUEGER PROPOSAL

Anne Krueger’s proposal quickly became the subject of intense discussion and debate. Indeed, as Lex Rieffel notes “representatives of the private sector reacted with horror for the most part”.⁸ At the Institute for International Economics, a Washington DC think-tank, on 1 April 2002, a distinguished group of speakers, including Krueger, presented arguments for and against the SDRM. Most surprising was the response of John Taylor, Under Secretary of the US Treasury for International Affairs, and one-time colleague of Krueger at Stanford. It was widely believed that Krueger, a Bush nominee with strong connections with the administration, including the US Treasury, would get her way with the SDRM. In fact, the Treasury initially supported her idea. However, Taylor proposed an alternative contractual approach involving the introduction of new clauses into bond contracts to facilitate debt restructuring because in the Treasury’s view the SDRM required more research and clarification before it could be made operational.⁹ To put it more bluntly, the US Treasury was dumping the SDRM in favour of collective action on new clauses in debt contracts.

⁸ Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington, D.C.: Brookings Institution Press, 2003), p. 5. Others have noted that “faced with the possibility of a more radical solution, market participants, until recently unrelenting critics of collective action clauses, embraced them as, from their perspective, the lesser of evils”. Barry Eichengreen, Kenneth Kletzer and Ashoka Mody, *Crisis Resolution: Next Steps*, IMF Working Paper No. WP/03/196 (Washington, D.C.: IMF, 2003).

⁹ John B. Taylor, “Sovereign Debt Restructuring: A US Perspective”. Remarks at the Institute for International Economics Conference on “Sovereign Debt Workouts: Hopes and Hazards”, Institute for International Economics, Washington, D.C., 2 April 2002.

Specifically, under the Treasury proposal, sovereign bonds governed by the laws of the United States, Germany, and other key jurisdictions would also include collective action clauses. However, it would be a particular type of a collective action clause—a majority action clause that would allow a supermajority of bondholders to alter the key financial terms of a bond. More importantly, it called for sovereign borrowers and creditors to insert a package of new “contingency clauses” into future bond contracts designed to set forth the modalities of a sovereign debt workout, and in particular, describe the process to be followed if restructuring proved necessary. These new types of clauses (dubbed “engagement clauses” and “initiation clauses”) would provide for early dialogue, coordination, and communication among creditors and a sovereign, and limit disruptive legal actions. Thus, the Treasury proposal envisaged what is called a “market-based and decentralized approach”. There were a number of reasons for this. First, the clauses themselves would be developed and agreed to by creditors and the issuers in a decentralized way. Sovereign borrowers along with their creditors and their lawyers would work out the details as new bonds would be issued. Eventually, new templates with these clauses would replace existing templates without the clauses. Thus, unlike the SDRM, the Treasury approach would focus on separately restructuring different types of debt on different bond issues. Second, in the event of a restructuring, the sovereign government and its creditors would work out the terms of the restructuring on their own guided by the clauses but without the involvement of a central group or panel. Third, the clause approach could be implemented quickly, while the SDRM approach would require a good deal of time in light of its relative complexity and the need to gain legislative approval, including in the United States. And, fourth, Taylor announced that the G-7 had endorsed the US position, while encouraging the IMF to continue to work to refine its plan.

In her presentation, Krueger politely noted that, “thanks in no small part to the many useful inputs we have received from academics, the private creditor community, non-governmental organizations, and our member countries ... our thinking has progressed since last November”.¹⁰ In a rather detailed document released in mid-April 2002 (and with the backing of the IMFC or the International Monetary and Financial Committee, the Fund’s policy-setting arm), Krueger’s revised proposal now included two complementary approaches deemed “critical” to an orderly and predictable process for sovereign debt restructuring.¹¹ Complementing SDRM was a contractual approach (the so-called “collective action clauses” or CACs), under which debt restructurings would be facilitated by enhanced use of certain contractual provisions in sovereign debt contracts.

¹⁰ Anne Krueger, “New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking”. Address at conference on “Sovereign Debt Workouts: Hopes and Hazards”, Institute for International Economics, Washington, D.C., 1 April 2002.

¹¹ Anne Krueger, *A New Sovereign Approach to Sovereign Debt Restructuring* (Washington, D.C.: IMF, April 2002).

Indeed, as noted earlier, the idea behind the use of CAC was hardly new. Contractual provisions designed to facilitate an orderly restructuring of problem debts have long been suggested as an alternative to expensive rescue packages for debtor countries, or those experiencing a sudden outflow of capital leading to a sovereign debt crisis. Collective-action clauses, which are typically included in bonds subject to UK law, allow a qualified majority of bondholders to pass binding resolutions altering the value and timing of interest payments. This contrasts with bonds subject to US law (in practice, the law of the State of New York) under whose terms the unanimous consent of all bondholders is required. The addition of such clauses is usually seen as a small step in the direction of providing some of the functions of an international bankruptcy court. In fact, this is exactly what was suggested by the G-10 following the Mexican peso crisis and endorsed in a series of G-7 and G-22 reports in the second half of the 1990s. Given the then US Treasury Secretary Robert Rubin's strong endorsement of collective-action clauses in 1999, and G-7 finance ministers endorsing them at their Cologne Summit, and at the beginning of 2000, the UK government issued an international bond including collective action provisions. In April 2000, the Canadian government committed itself to include collective-action provisions in all its future international bonds.¹² In 2003, Brazil in a US\$ 1 billion sovereign debt offering in the US market also announced that it was adopting CACs. Brazil decided to concentrate on clauses relating to the maturity date, interest rate and principal amount, and clauses to reduce the portion of the principal amount that is payable in the event of an acceleration of the maturity of the bonds, as well as other payment terms.¹³

Thus, Krueger noted that since the contractual approach is already an accepted practice in some markets (but, more universally in sovereign debt contracts), and the SDRM or the statutory approach designed to create a legal foundation for collective action among creditors, it would help bring about faster and more orderly restructuring. Specifically, Krueger pointed out that the CACs would have sovereign borrowers and their creditors put new clauses into their external bond contracts. The clauses would provide a roadmap describing as precisely as possible what happens when a country decides it has to restructure its debt. In this way the contracts would create a more orderly and predictable workout process. The CACs would apply to individual bond issues. Sovereign borrowers and their creditors would work out the details as the new bonds are issued. Under a majority action clause, it would permit a specified

¹² The specific collective action clauses that Canada intends to adopt include collective representation, majority action and non-acceleration clauses. Specifically, collective representation clauses facilitate restructuring discussions between issuers and bondholders. Majority action clauses are intended to prevent restructuring proposals from being blocked by minority bondholders. And, non-acceleration clauses are designed to help restructuring discussions by discouraging individual bondholder action to accelerate the terms of repayment.

¹³ Brazil became the first non-investment grade sovereign to issue bonds with collective action clauses in the US market when it completed an offering of US\$ 1 billion aggregate principal amount of 10 percent Global Bonds due 2007, on 6 May 2003. The new bonds contain collective action clauses, which permit certain amendments and waivers that formerly required unanimous consent to be approved by holders of 85 percent or more of the bonds. The clauses also require a vote of holders of not less than 25 percent of the bonds to accelerate the maturity of the bonds after an event of default—Brazil's prior debt issues had permitted each holder to accelerate its bond following the occurrence of certain types of events of default.

supermajority of holders of the bond issue to agree to a restructuring that would be binding on all holders of that issue. Moreover, the majority bondholders could change the financial terms of the bond, an engagement/representation clause to facilitate information flow between sovereign borrowers and their creditors and provide for the election of a bondholders' representative, and a clause limiting disruptive legal action. This would prevent hold-outs in individual bond issues, thereby facilitating any needed restructuring. A registry of holders, or trustee arrangements, could accelerate the process. Krueger noted that the use of such CACs would be an improvement over the current system and that the IMF is committed to promoting their use among its member countries.

IV. "COMBINING" THE SDRM AND THE CAC

No doubt, the absence of a predictable, orderly and rapid process for restructuring the debts of sovereigns remains a major problem. Currently sovereign borrowers often find it very difficult to get its creditors to agree collectively to a restructuring that reduces the net present value of its obligations to a manageable level. Even if such a restructuring would be in the interests of creditors as a group, some may prefer to "free-ride", hoping that they will ultimately be repaid in line with their original contracts.¹⁴ Similarly, a debtor country may all too often delay a necessary restructuring until the last possible moment, draining its reserves and increasing the eventual cost of restoring sustainability. Creditors also suffer when fears about some being unfairly favoured over others block agreement on a restructuring. Indeed, creditors often "rush to the exits" because they fear that restructuring will be disorderly. This can leave all parties concerned with no option but to accept a disruptive and potentially contagious unilateral default—or a bailout of private creditors that contributes to moral hazard. In the end the citizens of the defaulting country experience greater hardship than they need to, and the international community through the IMF has a tougher task, helping pick up the pieces.

Since there is currently no international insolvency code that can help a country and its creditors rapidly reach agreement on a restructuring (as is done with companies), sovereign debt restructuring too often spirals into a disorderly process, especially if some creditors hold out against an agreement reached by a majority of creditors. A formal restructuring mechanism like the proposed SDRM (modelled on corporate bankruptcy law) would allow countries to seek legal protection from creditors that stand in the way. In exchange debtors would have to negotiate with their creditors in good faith, besides pursuing policies that would help protect their claims. Indeed, a formal SDRM would greatly mitigate the problem because its five key principles (listed below) would provide protection to both creditors and the debtor.

¹⁴ For example, credit derivatives may provide investors with incentives to hold out in the hope of forcing a default, thereby triggering a repayment under the terms of the derivative contract.

- (1) Creditors would not be allowed to disrupt negotiations by seeking recourse in their own national courts. To this effect, the aim is to establish a statutory approach to establish a universal legal framework to facilitate negotiations and to empower a supermajority of creditors to approve a debt restructuring agreement with a debtor country. Minority creditors would be prevented from blocking such agreements.
- (2) Debtor countries would need to provide assurances that they are negotiating in good faith and treating all creditors equally. Moreover, the creditors would be given some assurances that the debtor will negotiate in good faith and will pursue policies—most likely to be designed in conjunction with seeking financial support from the IMF, that help protect the value of creditor claims and help limit the dislocation in the economy.
- (3) Private creditors would be encouraged to lend new money by receiving some guarantee that they would be repaid ahead of existing private creditors; and
- (4) A dispute resolution forum to oversee the process, including verify claims, ensure the integrity of the voting process, adjudicate possible disputes and certify the debt-restructuring agreement.
- (5) Once agreement on a restructuring has been reached by a large enough majority of creditors (about 75 percent), the rest would be bound to accept the terms.

A notable feature of the SDRM is that countries would come to the IMF and request a temporary standstill on their debts (probably lasting a few months), while the country negotiates a rescheduling or restructuring. Specifically, IMF endorsement of a request for debt restructuring would activate the standstill. Extensions would not only require IMF approval, a temporary stay (or standstill) on creditor litigation would be enforced while negotiations for a restructuring agreement were under way. This would help prevent a “grab-race” by individual creditors seeking to have their debts repaid ahead of others. Also, during the period of the stay, there would be limitations on the debtor’s actions to prevent it from harming the interests of creditors. As a further protection, the SDRM may also require the imposition of temporary exchange controls to stop sovereign default and money from fleeing the country, including debt held by residents, even if they are held in local currency.¹⁵ The reasoning is that residents might engage in financial abuses such as capital flight—and in the process upset asset values and the bond structuring programme, besides undermining the country’s ability to return to generalized debt servicing.

¹⁵ Of course, the advantages of controls have to be weighed against the risk that they might broaden a sovereign crisis to potentially solvent private firms. Krueger suggests that some mechanism could be designed to provide limited legal protection to otherwise viable domestic firms that might be prevented from servicing their debts solely by the controls. Moreover, controls should be accompanied by policies that would allow them to be lifted as soon as possible. That is, countries should not be encouraged to leave them in place longer than they are needed.

As Krueger has often noted, the primary objective in creating such a formal mechanism is to create incentives for debtors and creditors to reach agreement on their own, so the mechanism would rarely need to be used. Krueger makes it clear that the most innovative aspect of the SDRM is that it will enable a majority of creditors (across the broad range of credit instruments) to make the terms of restructuring binding on the rest. That is, all creditors would be obliged to comply with a plan approved by a large enough majority. Furthermore, a supermajority of creditors could vote to accept new terms under a restructuring agreement; minority creditors would be prevented from blocking such agreements or enforcing the terms of the original debt contracts. That is, they would be bound by the decision of the majority. How would decisions made by the debtor and a majority of creditors be made binding on all creditors? For Krueger, part of the solution is the wider use of CACs (which would allow a majority of creditors to impose a deal on the remaining minority), thereby help resolve some debt problems. Specifically, the sovereign debtor would have legal protection from disruptive legal action by creditors while negotiations were under way. This would be provided through a vote by a supermajority of creditors to approve a stay on litigation. Moreover, Krueger explicitly notes that the voting process would include the claims of all creditors regardless of the type of instrument (bonds, bank loans, derivatives) so that a comprehensive restructuring of all debt would be possible. She notes that this would help mitigate the free-rider problem, thereby making early agreement more likely, and reducing the threat of unilateral legal action by creditors after a sovereign default. Yet, fully aware that CACs will solve only part of the problem, she suggests that a universal treaty rather than piecemeal changes to national legislation is necessary. Such a treaty would set up an international judicial panel much like a formal bankruptcy court with universal force of law to arbitrate disputes, besides creating a single dispute resolution forum to assure integrity to the process and to avoid ambiguities of language or interpretation.

V. THE KRUEGER PROPOSAL: PROS AND CONS

During the debt crisis of the 1980s, collective action problems were limited by the presence of a relatively small number of large creditors, by contractual provisions in syndicated loans that deterred litigation, by the desire of banks to maintain good relations with the debtor to secure future business, and, on occasion, by moral suasion from supervisory authorities. Restructuring took time, but was in most cases orderly. However, the greater integration of capital markets and a shift from syndicated bank loans to traded securities and bond issuance have both had a profound impact on the way that emerging market countries finance themselves. Sovereign borrowers increasingly issue debt in a range of legal jurisdictions, using a variety of instruments, to a diverse and diffuse group of creditors. Different creditors have different time horizons for their investments, which means that they respond differently to economic shocks that affect a borrowing country's ability to service its debt. Moreover, these

changes have made creditor coordination much more cumbersome. This in turn has made it more difficult for all concerned to predict how the restructuring process will unfold. Many creditors now have no ongoing business relationship with the debtor to protect. Their interests are more diverse. They are less subject to moral suasion. And some now specialize in buying distressed debt cheaply and suing for full payment. Compounding this problem is the fact that far-reaching developments in capital markets over the past decade have not been matched by the development of an orderly, predictable framework for creditor coordination, in which the roles of the debtor, the creditors and the international community are clearly spelt out.

Krueger's proposal if comprehensively implemented would represent a significant improvement over existing arrangements. The new mechanism would create a more efficient debt restructuring process by allowing countries to resolve debt problems in an orderly way. Yet, the challenges to create an effective SDRM remain daunting. First, debt restructuring has become more complicated over the past two decades, in part because of the growing use of bonds and derivatives. Bondholders are more numerous, anonymous and difficult to coordinate than banks. They also have a bigger incentive to sue debtors for repayment. Getting them all to the table and to agree is easier said than done.

As noted earlier, from the time Krueger unveiled her initial proposal, it has faced a growing chorus of criticisms. Her revised proposal has hardly calmed the critics. For example, the George Soros Open Society Institute, along with several other non-governmental organizations (NGOs), have stated that they would only support an SDRM that included a mechanism to allow ordinary citizens to be involved in discussions on debt restructuring—thereby serving as a “partial remedy for the lack of democracy, transparency and accountability that exist in governments.” They also want the SDRM to cover IMF loans (other than concessional loans), and “that permitted loans extended to corrupt regimes be written off when creditors should reasonably have known about the corruption”.¹⁶ Moreover, NGOs have criticized the SDRM because of their concern that the Fund would continue to play a key role in assessing the sustainability of the country's external position, including its debt. This, they argue, not only puts the IMF in the position of dictating the terms of any settlement between a debtor country and its creditors, but also it is incompatible with the role of the IMF as a creditor itself, and, indeed, a preferred one.¹⁷ However, such arguments are misguided

¹⁶ The argument to cancel corruptly accumulated debt (or “odious debt”) remains highly problematic. The IMF has questioned its practicality until some key issues are first resolved. In particular, who decides which debt falls into the odious category? What criteria are to be applied in deciding who ought to bear the costs of dealing with odious debt? For example, if the odious debt deals were cut between one government and another, who should decide, and by what criteria, what balance should be struck between the wronged citizens of the debtor country and the taxpayers of the creditor country who would absorb the cost of the debt relief? *All sides have their say on SDRM proposal*, 31 IMF Survey 18 (7 October 2002), p. 297. Also see Romilly Greenhill, Ann Pettifor, Henry Northover and Ashok Sinha, *Did the G8 Drop the Debt* (London: Jubilee Debt Campaign, 2003).

¹⁷ Some have argued that in the interest of ensuring economic viability of the sovereign following debt restructuring as well as fairness in the treatment of all creditors, the coverage of debt under the SDRM should be widened to include the claims of official creditors (Paris Club) and international financial institutions. See *Views of SDRM Differ*, 32 IMF Survey 3 (17 February 2003).

for two reasons. First, the IMF since its inception has been treated as a preferred creditor by debtor countries and by other creditors such as private banks, capital markets, and bilateral official creditors because of the Fund's role in providing financing to its member countries in times of crisis—that is, when other sources of credit are not available. Thus, it is not only appropriate for the Fund to have preferred status, without such protection crisis financing would simply not be forthcoming. It also means that when debt relief is sought, the other creditors must provide a greater share of the resources than would be the case if the IMF comparably reduced its own claims. Secondly, since the integrity of the process would be ensured through the Sovereign Debt Dispute Resolution Forum—which would be independent of the Fund—the claim that the IMF would dictate terms is not compelling.

More troubling, a wide array of creditors' lobbies (representing investors, international banks and those involved in bond issuance and trading) has been against it.¹⁸ They have questioned the competence of the IMF to act as an arbiter when the Fund itself is a creditor, besides suggesting that the Fund is pushing for the SDRM because it considers bonds easier to restructure as the necessary antidote to so-called official sector bail-outs.¹⁹ Their other concerns include: How would an SDRM work, and who would decide whether a country's sovereign debt burden is unsustainable? Would all sovereign debt be covered? What would be the IMF's role? And, how might the SDRM affect private sector flows to emerging markets and borrowing costs?

To meet the growing chorus of criticisms, Krueger has continued to modify her proposals. She has proposed that an independent dispute resolution forum (possibly serving as a judicial body within the IMF) would be established to verify claims, ensure the integrity of the voting process, and adjudicate inter-creditor disputes that might arise, and arbitrate on claims. The IMF's role would continue to be that of signalling its willingness to provide financial assistance for the government adjustment programme, rather than getting in the middle of discussions between creditors and debtors. Even if the judicial body was set within the IMF, Krueger has assured that this will not involve a major extension of the Fund's legal authority. Instead, it could be agreed that control over the key decisions would rest with the debtor and a supermajority (about 75 percent) of the creditors. But, so far this has been to no avail.

¹⁸ For example, see the 3 June 2002 joint letter from representatives of the Emerging Markets Traders Association, the Institute of International Finance, the International Primary Market Association, the Bond Market Association, the Securities Industry Association and the Emerging Markets Creditor Association, to former US Treasury Secretary O'Neill available at <<http://emta.org.ndevelop/oneill.pdf>>. Also see EMTA Bulletin 2 (3rd Quarter 2002).

¹⁹ Responding to such criticism Krueger has replied that, "People have questioned whether it would be appropriate for the Fund to interfere in the relationship between debtor and creditors, and to impose the terms of a restructuring on them. The simple answer is that we would have no intention of doing so and could not do so. The Fund would be mandating the process within which a restructuring would be negotiated, but not the outcome. The restructuring terms would emerge from negotiations between the debtor and creditors. But once the necessary majority of creditors had agreed the terms, the mechanism would make it possible to bind in minority creditors, thereby resolving the collective action problem." Also see, Jack Boorman, *Alternative Approaches to Sovereign Debt Restructuring*, 23 *Cato Journal* 1 (Spring-Summer 2003), pp. 59–71.

It seems that the real bone of contention lies in Krueger's oft-repeated statements that while the more ambitious use of collective action clauses could contribute significantly to more efficient sovereign debt restructuring, a purely contractual approach cannot resolve all the weaknesses of the current system. Put bluntly, this implies that any new framework to encourage more orderly and timely debt restructuring would require a statutory basis. To this, the private sector lobbies have argued that the proposed SDRM is not only unnecessary, but it also abrogates investor rights. They note that the current system is actually working quite well. It has not prevented sovereigns restructuring their liabilities via exchange offers in which bondholders voluntarily tender their existing securities for new securities that modify (and effectively reduce) the sovereign's payments structure into a sustainable stream of payments. They have repeatedly drawn attention to the fact that Pakistan, Ecuador, Ukraine and Russia have all managed to restructure their debts (besides securing debt service relief and write-downs of principal) under such exchanges, even in circumstances where there were large numbers of diverse creditors.²⁰ Except in the case of Peru, there was no other instance where governments did not get the cooperation of bondholders. Second, the lobbies fear that Krueger's proposal will make default an easy way out. However, the Fund has noted that the prospect of economic dislocation, political upheaval, and possible long-term loss of access to international capital markets will still make countries loath to default on their debt service obligations in all but the most extreme circumstances. Third, the critics point out that sovereign debtors already have certain rights—namely, sovereign immunity and the ability to determine domestic policies with no input from creditors—that do not exist in domestic bankruptcy systems.

Thus, not only are there good reasons not to give sovereigns some of the protections available to debtors in domestic systems, any attempt to make defaults smoother is misguided because default should not be made too easy for debtors. Indeed, the lobby has suggested that if any changes are to be made, it must include strengthening creditor rights, rather than making restructuring easier for debtors. Of course, these claims run counter to the Fund—which has observed that in most recent bond restructuring programmes, there has been no reduction in debt. It is because the countries in crisis negotiated from a position of weakness. Suffice to note, the situation would be reversed if debtors negotiated under the cover of the SDRM and banks might have to reduce their claims. Clearly, this prospect has disturbed the bankers more than any other. Finally, emerging market countries have raised concerns that the mechanism will make it more expensive for them to access foreign capital. The Fund has

²⁰ Ukraine is an interesting case in point. Ukraine's restructuring is frequently held up as a successful example. But even in this case, complications arose because one of Ukraine's bonds in the restructuring did not have majority action clauses. As a result, the authorities needed to track down the bondholders and try to secure 100 percent consent to amend the financial terms of their bonds. This proved especially difficult because retail investors owned a large portion of this bond. Nevertheless, these problems were not insurmountable in the case of Ukraine largely because the authorities had only a small number of external debt instruments outstanding. Of course, this is not the case for many other emerging market countries.

downplayed this distinct possibility, arguing that a more orderly and predictable framework would help lenders and investors discriminate between good and bad risks more effectively. That is, by reducing moral hazard and making borrowing costs better reflect true risks, should help countries with good policies attract capital more cheaply, while at the same time help prevent countries with weak policies from building up excessive debts that might leave them vulnerable to potential crises. While the Fund has correctly noted that in the long run the SDRM will make it easier and cheaper for emerging market countries with strong policies to access foreign capital, such arguments have hardly quelled private sector concerns.

However, a purely contractual approach cannot resolve all the weaknesses of the current system. For example, a recent study by Barry Eichengreen and Ashoka Mody finds that contrary to the view of many policymakers, including market participants, collective-action clauses in fact reduce borrowing costs for the most creditworthy borrowers, while raising it for less creditworthy borrowers—often the poorest countries.²¹ Specifically, they find that collective-action clauses raise borrowing costs for less credit-worthy borrowers (by on average 150 basis points), while lowering them for more creditworthy borrowers (by on average 50 basis points).²² These findings are significant (relative to a typical emerging-market spread of 600 basis points). Indeed, these findings should be taken seriously as Eichengreen and Mody's study compares the spreads on British-style bonds in the London market (where collective-action clauses are typically present), and equivalent US-style instruments—where such clauses are typically absent.²³ Their data, from the Capital Bondware database, contain 2,619 bonds—virtually every international bond (municipal, state, corporate and sovereign alike) issued by emerging markets between 1991 and 1998. Focusing on bonds subject to UK law and US law, Eichengreen and Mody analyse the impact of legal provisions on spreads, while factoring in such variables as the maturity of the issue, whether it was privately placed, whether the issuer was private or governmental, the currency in which the issue was denominated, whether the interest rate was fixed or floating, global financial conditions, and a variety of country characteristics such as macroeconomic variables, financial variables, including a measure of political risk. Eichengreen and Mody's analysis underscores the fact that while more credit-worthy borrowers benefit from the ability to avail themselves of an orderly restructuring process, for less creditworthy issuers the benefits are offset by the moral hazard and additional perceived default risk associated with the presence of renegotiation-friendly loan provisions and greater ease of restructuring. In the short run, mandating the

²¹ Barry Eichengreen and Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, NBER Working Paper No. 7458 (2000).

²² In other words, Eichengreen and Mody believe that those who enjoy a rating of above 50 on the Institutional Investor scale benefit because of advantages of provisions facilitating an orderly restructuring.

²³ Since British law provides for holders of debt securities to call a bondholder assembly with the power to appoint a representative to negotiate with the debtor, including the provision for majority voting with a resolution binding on all bondholders, providing the required majority has agreed, the authors make allowances for the different sorts of borrowers operating under the two regimes and for the currency vehicle.

inclusion of collective-action clauses would thus mean higher borrowing costs for low-rated sovereign borrowers, typically the governments of the poorest countries. In the long run, however, it would apply additional pressure, through market discipline, for them to upgrade their economic and financial practices and improve their credit worthiness. Eichengreen and Mody conclude that the results of their research “do not support the dire consequences predicted by some market participants of including collective action clauses in loan contracts”. Thus, if reform of the global financial architecture is to strengthen market discipline:

“... by encouraging investors to more generously reward more creditworthy borrowers and penalize less creditworthy ones, then more widespread adoption of collective action clauses, which would reduce borrowing costs for the more creditworthy while raising them for their less creditworthy counterparts, would seem to be a step in the right direction.”

A more benign finding is presented in a recent article by Mark Gugiatti and Anthony Richards.²⁴ The authors provide new empirical evidence regarding the way financial markets and the international community deal with sovereign debt crises. In particular, given the opposition investors and some sovereigns have to the greater use of collective action clauses in emerging market bonds, the paper presents new evidence on the way that financial markets have priced the use or non-use of CACs. Gugiatti and Richards supplement existing evidence that the use of CACs in Euromarket issues has not affected yields on new bond issues through an event study that shows that decisions by issuers to change away from, or to, the use of CACs has also not affected the pricing of issuers' existing stock of debt in the secondary market. They also provide new evidence on the pricing of a large sample of bonds in the secondary market on 31 January 2003. Their data show that even after the intense debate about sovereign debt restructuring through 2002, the inclusion or absence of CACs still had no economically or statistically significant impact on yields as of early 2003. Hence the authors conclude that either the investors still had not focused on which bonds have CACs, or that they believe that the inclusion of CACs is not relevant to the pricing of debt. The authors claim that the empirical evidence suggests that there is no good reason why there cannot be greater use of CACs, including in bonds sold into the US market. They argue that investors will benefit from well-targeted reforms in the way that sovereign debt crises are handled. Indeed, Mexico's successful sale of global bonds with CACs on 26 February 2003 (the first placement of bonds with CACs by an emerging market sovereign into the US market) suggests that the long-held opposition to CACs in some quarters may be easing.

Nevertheless, by itself, the Treasury's modified CACs is no panacea because it does not automatically ensure an orderly restructuring or universal coverage of sovereign debt. Collective action clauses can make a useful contribution to the

²⁴ Mark Gugiatti and Anthony Richards, *Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets*, Discussion Paper RDP2003-02 (Sydney: Reserve Bank of Australia, 2003).

resolution of debt problems, especially in cases of illiquidity where a smoothing-out of the debt service profile is required rather than a reduction in the net present value of the sovereign's overall obligations. In fact, clauses work most effectively only on a bond-by-bond basis—therefore, a debtor country would need a supermajority of holders of every bond to agree to a restructuring.²⁵ When multiple bond issues need to be restructured, clauses cannot prevent difficulties if a group of holdout investors obtains control of an individual bond issue. Second, the new clauses would only apply to new bonds and would therefore impact a relatively narrow scope of debt. On the other hand, the SDRM would immediately cover all existing external sovereign debt once the statute becomes effective—unlike in CACs where it will take some time before clauses are included in all outstanding sovereign debt. Third, the Treasury's new clauses would not allow for aggregation of debt across different instruments. That is, whereas clauses bind holders only within the same bond issue, the SDRM would allow different bond instruments to be aggregated into a single vote on the proposed restructuring, as in a commercial debt restructuring. Yet, it should be noted that while the SDRM would eliminate certain legal impediments to a rapid and orderly debt restructuring, it would not remove the need to work out the macroeconomic policy adjustments required for the country to meet payments on its rescheduled debt. Finally, if a country faces a genuinely unsustainable debt burden and a solvency crisis rather than a short-term liquidity problem, private creditors need to share the burden of restructuring by limiting their demands for repayment or even agreeing to reduce the real value of their claims.

Yet, questions regarding what financing the IMF should provide after the restructuring, or to what type of debt the stay should apply, will need to be resolved first. Similarly, sensitive issues regarding how countries that may be tempted to appeal for debt relief through such mechanisms when such relief is not warranted can be prevented from abusing the system needs to be resolved. After all, countries facing severe liquidity problems go to extraordinary lengths to avoid restructuring their debts to foreign and domestic creditors because they know that even an orderly debt restructuring can damage their economy and banking system.

Given these challenges, it is better that the SDRM be institutionalized through an amendment of the IMF's Articles of Agreement rather than through a new international treaty—as Krueger proposal states. While a treaty would assure legal uniformity across all jurisdictions, besides preventing conflicts arising from different interpretations in different jurisdictions, creating a new international treaty would likely be a complicated and uncertain undertaking. An international treaty would not only require unanimous vote and ratification by domestic parliaments, withdrawing from a freestanding treaty after submitting a three-month notice and without any serious ramifications may prove an easy-out have to the withdrawing country. On the other hand, while an amendment

²⁵ This is because CACs only bind holders of a single bond issue—leaving unresolved the aggregation problem of binding bondholders across different classes.

to the IMF's articles would be required for the proposal to move to the operational stage, such an amendment can take effect immediately when three-fifths of the members having 85 percent of the voting power support it. Although such an amendment is hardly guaranteed as it will require 60 percent majority of all IMF members, including members accounting for 85 percent of the voting power, this approach is still more feasible than getting every country to amend its domestic bankruptcy law.²⁶ Moreover, unlike an international treaty, withdrawing from the Fund will entail costs because it will deprive the country of the benefits of membership provided for under the articles of agreement.

VI. FUTURE PROSPECTS

Will the CAC effectively pre-empt the SDRM? The answer seems to be an unequivocal yes. It is worth noting that in April 2002, the finance ministries and central bank governors of the G-7 countries agreed on an historic G-7 Action Plan for emerging markets. The plan called for the immediate introduction of collective action clauses into sovereign debt contracts and further development of a sovereign debt restructuring mechanism.²⁷ In September 2002, representatives of the private sector, senior officials from the G-7 and senior officials from some key emerging markets met at the US Treasury (the first meeting of this kind ever), to discuss key aspects of collective action clauses. As expected, the private sector supported limited use of collective action clauses provided it includes the use of supermajority clauses (90–95 percent) to amend payment and other important contract terms, and is supplemented with mechanism to help protect investor rights by providing for clearer documentation standards, as well as early warning of possible credit deterioration. However, they strongly rejected the SDRM. Many of the emerging market countries expressed support for the collective action clauses, but disapproval of the SDRM. Similarly, all the G-7 officials reiterated their governments' support for incorporating collective action clauses immediately, in addition to requiring that any sovereign—including any member of the G-7—that issues bonds governed by the jurisdiction of another sovereign should include collective action clauses. For example, the US authorities not only endorsed their strong support for countries including collective action clauses in external bond issues, the US Treasury also announced its decision to encourage all countries that issue external bonds under New York law to include collective action clauses in their offerings. This constitutes the strongest statement of support for collective action clauses ever issued by the United States and the G-7—albeit neither ruled out the SDRM—recommending the continuation of work on a more specific proposal for the SDRM.

²⁶ The IMF's articles of agreement have been amended before and it is therefore a process familiar to the organization's members.

²⁷ John B. Taylor, *Increasing Economic Growth and Stability in Emerging Markets*, 23 *Cato Journal* 1 (Spring-Summer 2003), pp. 127–134.

In December 2002, the Fund's executive board and the IMFC, which represents the interests of the IMF's 184 member countries, formally encouraged Krueger to investigate a "twin-track" approach for consideration at the IMFC's April 2003 spring meeting. The approach was to include both a statutory approach to create a legal framework that would allow a qualified majority of a country's creditors to approve a restructuring agreement which would be binding on all, and a contractual approach to incorporate comprehensive restructuring clauses, so-called "collective action clauses", in debt instruments. The board noted that:

"... the SDRM must only address collective action problems among creditors, but also catalyze an early and effective dialogue and exchange of information between the debtor and its creditors. By creating greater predictability in the restructuring process, the SDRM should also be expected to improve the functioning of international capital markets—an objective that should remain a primary concern going forward."²⁸

The IMFC held its seventh meeting in Washington, D.C. on 12 April 2003. As expected, it welcomed the inclusion of CACs by several countries, most recently Mexico and Korea, in international sovereign bond issues. At that meeting, US Treasury Secretary John Snow issued a statement noting that:

"... creating a more orderly and predictable process for debt restructuring has been a particular priority in recent months. The United States welcomes the excellent progress made in developing and incorporating collective action clauses in external sovereign bond contracts. Mexico has shown strong leadership in issuing several bonds that include such clauses and committing to include such clauses in all new bond issues. Mexico's successful issuances demonstrate that emerging market countries can follow a contractual approach that would help promote a more orderly restructuring process. We urge other emerging market borrowers to follow Mexico's lead."²⁹

A few weeks later, the IMFC also announced its ringing support of the policy that by June 2003 those EU countries issuing bonds under foreign jurisdictions will include CACs. In addition, the IMFC praised the work of the G-10 emerging markets, and the private sector in contributing to the development of CACs and the inclusion of CACs in international bond issues becoming standard market practice. It instructed the IMF to promote the voluntary inclusion of CACs in the context of its surveillance, besides formulating a voluntary code of conduct for debtors and their creditors. The IMFC also endorsed the work of the IMF in developing a concrete proposal for a statutory sovereign debt restructuring mechanism. Although the IMFC acknowledged that it was not feasible now to move forward to establish the SDRM, it strongly supported that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises. These issues include inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues. Nevertheless, while the board recognizes that institutional reforms will make it easier

²⁸ *IMF Board debates SDRM design*, 32 IMF Survey 1 (23 January 2003), pp. 2–3

²⁹ Statement by Treasury Secretary John Snow before the International Monetary and Financial Committee of the IMF, IMF Office of Public Affairs, 12 April 2003.

for the private sector to restructure unsustainable sovereign debts, besides providing a viable alternative to IMF financial assistance, the reality is well noted by Paul Blustein:

“The top International Monetary Fund official who advanced a radical proposal to create an international ‘bankruptcy’ system for countries has privately acknowledged that the plan has failed to win enough support to move forward, according to people familiar with the matter. Although she didn’t pronounce the plan completely dead, Anne O. Krueger, the IMF’s first deputy managing director, conceded that because of insufficient political backing there is at present no chance for the legal changes necessary to establish a ‘sovereign debt restructuring mechanism’ or SDRM . . . In another sign that the plan is about to be shelved, John B. Taylor, the US undersecretary of the Treasury for international affairs, said . . . that fierce opposition means the IMF proposal ‘is not practical right now’. Bush administration officials have been major skeptics, together with private international financiers and the governments of many emerging market nations. The comments appear to herald the end of an extraordinary effort by the IMF’s management and staff to reshape the rules of the international economy with the aim of providing a new approach for dealing with financial crises. That leaves the way clear for a ‘voluntary’ approach that Taylor proposed, in which emerging market countries borrowing money would be encouraged to issue bonds with ‘collective action clauses’. Taylor, while stressing that the debate on the SDRM ‘has been very useful’ said ‘from a practical perspective, for now the clause approach is the one we should be focusing on’.”³⁰

During the latter part of 2003 and early 2004, sovereign issues containing CACs grew to represent more than 75 percent of total value of bonds issued in that period. In September and November 2003, Turkey and Peru included CACs in their bonds governed by New York law. These were the first non-investment grade countries to issue New York law bonds with CACs. Since the beginning of 2004, Chile, Panama, Colombia, Costa Rica and Venezuela completed successful bond issues, including CACs for the first time. Brazil, Turkey and Mexico’s recent issues again included CACs—joining Belize, Guatemala, Korea, Italy, Poland, South Africa and Uruguay which included CACs in bond issues last year. By such action, these countries are making collective action clauses the market standard in external sovereign bond issues under New York law. In its most recent communiqué, the IMFC welcomed the inclusion of CACs by an increasing number of countries in their international sovereign bonds and called on the IMF to promote the voluntary use of CACs by other countries. The committee also encouraged the IMF to continue to contribute to the efforts led by sovereign debtors and private creditors to develop a voluntary “Code of Conduct”, including the ongoing work on issues of general relevance to the orderly resolution of financial crises through the use of aggregation clauses.³¹ It is important to note that while the committee recognizes that aggregation can contribute to the resolution of both the collective action and creditors’ coordination problems by binding minority creditors across (as opposed to within) issuances, they also note that there are a number of risks associated with such a mechanism. Aggregation could give rise to inter-

³⁰ Paul Blustein, “Bankruptcy System for Nations Fails to Draw Support”, *Washington Post*, 2 April 2003, p. 15.

³¹ IMF, *Progress Report to the International Monetary and Financial Committee on Crisis Resolution* (Washington, D.C.: IMF, April 2004).

creditor equity concerns where, for example, a majority of creditors holding certain claims imposes an agreement on a minority that holds very different claims. An additional risk arises from possible manipulation of the voting process by the sovereign debtor. On the other hand, a voluntary code of conduct respected by sovereign debtors and private creditors could, in principle, facilitate dialogue between creditors and debtors, promote corrective policy action to reduce the frequency and severity of crises, and improve the prospects for an orderly resolution of crises.

VII. CONCLUSION

Clearly, an ideal debt restructuring reform would seek to achieve the following objectives: (a) discourage countries from over-borrowing and creditors from over-lending, (b) reduce the likelihood of sovereign debt crises by reducing moral hazard. This can be effectively done by ensuring that creditors who were compensated *ex ante* to bear risk, share appropriately in the *ex post* losses, (c) before the debt burdens become unsustainable, reduce the recognition lag during which economic conditions deteriorate to the disadvantage of the debtor country and creditors before beginning the restructuring process, (d) once the debt restructuring process has begun, ensure a prompt resolution, and (e) try to reach a resolution that will enable the country to regain access to stable capital flows.

Suffice to note, neither the SDRM nor the CACs by themselves will resolve the problem of sovereign debt, nor are they the right solutions for all crises or even the entire solution for those crises that make a sovereign debt restructuring necessary. Clearly, the improved sovereign debt process will only deal with some crises since not all crises are related to the sustainability of sovereign debt issued in foreign jurisdictions. Currency and maturity mismatches in the private sector, exchange rate pegs, poor supervision of financial institutions, and indexed domestic debt are other potential sources of financial crises.

Yet, countries will continue to need temporary financial support to see them through a genuine liquidity crisis, especially one that has its origins in external market conditions rather than in domestic policy. In such cases, official financial support via the IMF may be necessary. Thus, complementary measures such as strengthening the assessment of debt sustainability, improving the predictability of access to exceptionally large sums of IMF financing, revamping current lending facilities, and clarifying rules on IMF lending to countries that are behind on payments to private creditors need to support the work under way. Nevertheless, the failure to deal with the problem of sovereign debt will leave the international community with the unpalatable choice of accepting a disruptive and potentially contagious unilateral default, or bailing out private creditors and thereby contributing to moral hazard.

As the recent case of Argentina dramatically illustrated, the economic collapse that occurs when governments default is usually the result of reluctance on the part of the authorities to confront the underlying policy problems or to approach the creditors for

relief when debts have become unsustainable. In too many cases, the authorities “gamble for redemption” by taking high-interest loans to repay pending ones and experiment with ill-devised policy measures rather than face the uncertainty of approaching the countries’ private-sector creditors for the needed help.³² This problem persists in large measure because at present there is no mechanism to assure that governments that approach their creditors will be able to reach a negotiated settlement and restructure their debts that is consistent with their capacity to pay. Moreover, they have no assurance that the process of negotiating with creditors will be orderly, predictable, and transparent. In the end both creditors and ordinary citizens, especially the poor, suffer the most as a result of the economic fallout from financial crises. It is because of this that the current proposals on sovereign debt restructuring need to be taken seriously.

While the IMF’s exploration of a sovereign debt restructuring mechanism has raised important issues, given the reactions of markets, the G-7 and various emerging market countries, it is clear that the stakeholders are moving forward with collective action clauses. As US Treasury Secretary Snow bluntly put it:

“... these clauses, and not a centralized mechanism, are the vehicle to resolve the issues connected with sovereign debt restructuring. There can at times be ‘collective action’ problems that prevent a prompt, orderly resolution of a sovereign debt crisis. The source of these problems lies in the relationships and agreements of debtors and their creditors. It is these parties, not an international organization that must assume responsibility for the solution. Therefore, it is neither necessary nor feasible to continue working on SDRM.”

Nevertheless, in coming weeks, efforts to strengthen the crisis resolution framework through broad voluntary approaches will, no doubt, continue. However, only time will tell if collective action clauses coupled with enhanced transparency and disclosure can provide for a more stable and orderly international financial system.

³² Sometimes private creditors actively support this gambling by agreeing to lengthen repayment schedules in return for higher interest payments.