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TRANSNATIONAL GOVERNANCE IN GLOBAL FINANCE

THE PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS

Raymond Ritter

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THE PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS[1]

by Raymond Ritter[2]

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ABSTRACT

This paper analyses and assesses the track record and effectiveness of the so-called "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets", which have emerged as an important instrument for crisis prevention and crisis resolution in the international financial system. The paper argues that, notwithstanding their low profile, the Principles which were jointly agreed between sovereign debtors and their private creditors in 2004 have proved to be an effective instrument in spite of their voluntary and non-binding nature. Indeed, an increasing number of sovereign debtors and private creditors have adopted the Principles' recommendations on transparency and the timely flow of information, close dialogue, "good faith" actions and fair treatment. Two elements have been critical to the success of the Principles: (i) their specific design feature as a soft mode of governance agreed by a transnational public-private partnership and (ii) the "hardening" after their launch in terms of precision and delegation, thus moving them somewhat along the continuum of soft law and hard law towards the latter. The paper also makes the case that the Principles and their design features can provide some lessons for the current international policy debate on codes of conduct in global financial regulation.

Keywords: crisis prevention, debt restructuring, sovereign default, soft law, transnational public-private partnership, global financial governance.

JEL: F34, F51, F53, G15, G18.

NON-TECHNICAL SUMMARY

Strengthening mechanisms for crisis prevention and crisis resolution figured prominently on the agendas of international institutions and forums at the end of the 1990s and the beginning of this decade. This focus was triggered by the various emerging market crises that had led to protracted debt restructuring processes in a number of cases. What has crystallised over the past few years as an important tool for crisis prevention and crisis resolution in the international financial system is an often little-noticed yet innovative soft mode of governance, the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" (hereafter the "Principles"). Jointly established by sovereign debtors and their private creditors and investors in autumn 2004, the Principles complement the policies and rules set by international institutions and forums, most notably the International Monetary Fund (hereafter IMF or the "Fund") and the Paris Club, as well as the collective action clauses contained in international bond contracts. The Principles have been operating successfully for a few years now and have emerged as a valuable component of the international financial architecture. These voluntary and non-binding rules, which are the product of a transnational public-private partnership (PPP), seek to guide and structure cooperative actions of sovereign debtors and their private creditors and investors both during normal times as well as periods of financial distress. The key goals of the Principles are to foster transparency and the timely flow of information, close debtor-creditor dialogue, "good faith" actions and fair treatment.

In analysing and assessing their creation and implementation, this paper finds that the Principles provide a useful forum for interaction which, by relaxing information constraints and promoting mutual trust, fosters collaborative approaches. Serving as a focal point that facilitates the convergence of the negotiating positions of debtors and creditors, they help develop a shared understanding and increase the predictability of actions of the various parties. As a result, the Principles improve overall transparency and risk management in the global financial system.

To better understand the Principles' formula for success and to explain why commitment to, and compliance with, the Principles is advancing, the paper takes a closer look at their specific design features and characteristics. It sets out how sovereign debtors and their private creditors and investors – in the face of the perceived threat of government regulation in the area of sovereign debt restructuring – managed to agree on the Principles as tool of joint governance and in so doing resorted to soft law to order their relations. Reflecting the mutual interests of the parties involved, it is this very mode of governance and its related benefits that made it possible for state and non-state actors to join forces and pull together. The paper also shows that since their launch in 2004, steps have been taken to ensure the continuous usefulness of the Principles to sovereign debtors and private creditors by adapting them to the evolving interests of the parties concerned. More specifically, a change in their degree of legalisation has led to a shift of the Principles along the continuum of soft law and hard law towards the latter.

Looking at further incentives for sovereign debtors to comply with the Principles, the paper argues that implementing the Principles can usually be expected to be in the self-interest of a sovereign debtor if implementation is perceived by market participants as a reputation-enhancing action, leading to improved capital market access. Implementation could also be beneficial to the debtor in those cases where the negative reputational effects of non-implementation, and the ensuing impaired standing in capital markets, are avoided.

Going forward, the paper considers a number of steps to strengthen further the implementation process of the Principles. In addition to incorporating the Principles into the international policy dialogue, the paper sees merit in assessing in more detail the behaviour of creditors and investors in the context of implementation of the Principles. Moreover, the

issue of communication of information on the Principles' implementation into the marketplace is discussed. Taken together, these steps are conducive to raising further awareness and support for the Principles and anchoring their implementation process, thereby helping put the Principles on a path towards becoming a market standard and increasing the resilience of the global financial system.

As regards possible lessons that could be drawn from the experience with the Principles as a successful and effective code of conduct for the current international policy debate on global financial regulation, the paper stresses the importance of the incentive structure of a code as well as the reputational effects associated with compliance. Moreover, striking an appropriate balance between a code's generality and its level of specificity is regarded as crucial. Getting a code's degree of legalisation "right" is a key and ongoing challenge that needs to be successfully met if a code is to maintain credibility and hence its relevance in the governance of the international financial system.

" ... We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development ..."

Declaration of the Summit on Financial Markets and the World Economy, Washington DC, 15 November 2008.

I INTRODUCTION

The current financial crisis has led to a wide-ranging debate on the set-up and functioning of the international monetary and financial system. Various rules and regulations are being assessed, and the role of state and non-state actors in the international system is being scrutinised. Moreover, the mandates and formats of international institutions and forums, which are charged with making the global financial system safer and more resilient to crises and turmoil, are subject to discussion.

The past financial crises that hit the emerging market world for much of the 1980s, 1990s and the beginning of this decade also focused policymakers' attention on the functioning of the global system and played a pivotal role for the re-design of the international financial architecture. What has crystallised over the last few years as an important tool for crisis prevention and crisis resolution in the international financial system is an often little-noticed yet innovative – and at the current juncture very timely – soft mode of governance, the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" (hereafter the "Principles"), that was established jointly by sovereign debtors and their private creditors and investors in autumn 2004. Complementing the policies and rules set by international institutions and forums, most notably the International Monetary Fund (hereafter IMF or the "Fund") and the Paris Club, as well as the collective action clauses contained in international bond contracts, the Principles have been operating successfully for a few years now and have emerged as a valuable component of the international financial architecture. These voluntary non-binding rules, which are the product of a transnational[3] public-private partnership (PPP), seek to guide and structure cooperative actions of sovereign debtors and their private creditors and investors both during normal times as well as periods of financial distress. The key goals of the Principles are to foster transparency and the timely flow of information between debtors and creditors and to ensure close debtor-creditor dialogue and cooperation to avoid debt restructuring. In cases where debt restructuring becomes inevitable, the Principles aim to facilitate a voluntary restructuring process based on good faith and ensure the absence of unfair discrimination among affected creditors.

The purpose of this paper is to analyse and assess the creation and implementation of the Principles and to draw some possible lessons from the experience gained so far for the current policy debate on codes of conduct in global financial regulation. The paper argues that the Principles, although voluntary and non-binding in nature, have proved to be an effective instrument for crisis prevention and crisis resolution that is complied with by an increasing number of debtors and creditors. Soft modes of governance can hence play a useful role in facilitating interactions between various actors at the international level and allow for the provision of global public goods.

The paper is organised as follows. Section 2 analyses the development of the Principles in the historical context of international policy discussions on strengthening the global financial architecture following the various emerging market financial crises of 1997-2002. Further, it sets out the main content of the Principles

3 Transnational relations are defined as interactions across national boundaries when at least one actor is a non-state actor (see Nye/Keohane (1971), p. xii).

and describes their implementation process. Section 3 takes a closer look at the specific design features of the Principles and appraises them as a product of a transnational PPP. It also identifies the reasons as to why sovereign debtors and their private creditors and investors chose a soft mode of governance to organise their relations. Next, a set of differentiated criteria of legalisation is applied to gain some insight into how the Principles have evolved over time along the continuum of soft law and hard law. Moreover, turning to their implementation, the reputational effects for sovereign debtors of (non-)compliance with the Principles are analysed, and proposals of how to strengthen further implementation are presented. Section 4 looks at possible lessons that could be drawn from the experience with the Principles for the current international policy debate on codes of conduct in global financial regulation. Some concluding remarks are offered in Section 5.

2 THE PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS

Strengthening mechanisms for crisis prevention and crisis resolution figured prominently on the agendas of international institutions and forums at the end of the 1990s and the beginning of this decade. The focus was triggered by the various emerging market crises that had led to protracted debt restructuring processes in a number of cases.[4] Indeed, in the face of expanding bond financing by emerging market sovereigns and an increasingly spread and diversified investor base, difficult sovereign debt restructurings occurred because of collective action problems arising in the interactions between sovereign debtors and their private creditors.[5] Concerns grew *inter alia* over successful holdout strategies against sovereigns that had already restructured their bond debt. Hence, it was the absence of a clear and predictable framework in this area that focused the international policy debate on approaches to ensuring that processes of sovereign debt restructuring are predictable and orderly.

2.1 THE DEVELOPMENT OF THE PRINCIPLES IN HISTORICAL CONTEXT

Two key approaches to avoiding disorderly processes of sovereign debt restructuring were at the centre of the international policy debates that took place at the beginning of this decade.[6] The first one, the so-called statutory approach, was based on an IMF proposal for a "Sovereign Debt Restructuring Mechanism" (SDRM), an early version of which was presented by Anne Krueger, the IMF's then First Deputy Managing Director, and her staff in late 2001. The main idea behind the international bankruptcy regime was to allow a qualified majority of creditors to approve a restructuring agreement which would be binding on all creditors.[7] While this approach initially received the backing of the international community, it quickly met with resistance from various quarters, including several emerging market countries, the United States and the financial industry. In the end, at its Spring Meetings in 2003, the IMF acknowledged that establishing the SDRM at that juncture had proven to be infeasible.

At the same time, a non-statutory or market-based approach to sovereign debt restructuring emerged, consisting of two complementary legs: (i) collective action clauses (CACs) included in international bond contracts and (ii) the Principles. The first leg of this market-based approach is the inclusion of CACs in international bond contracts. CACs formulate a set of rules applicable to the main decisions of the debt restructuring process and constitute a decentralised response to collective action problems between bond creditors.[8] It may be recalled that there was not much enthusiasm for this concept back in 1996 when the G10 Rey Report and its recommendations promoting such clauses were released. The changing international financial landscape, however, and experience with the debt crises of the 1990s generated increasing interest in CACs. The letter that the so-called "gang of six" – a coalition of six groups representing international investor interests, including the Institute of International Finance (IIF) – sent to the G7 in May 2002 made it clear that the private sector had warmed to the concept of CACs.[9] Work continued in this area, with the G10 Quarles Report as well as the private sector developing model clauses. After the Mexican

4 See Sturzenegger/Zettelmeyer (2006) for an excellent overview of recent sovereign debt restructurings.

5 Potential collective action problems that can occur in the course of a sovereign debt restructuring process include a "rush to the exit" by creditors from the sovereign's debt and litigation initiated by creditors before or after the debt restructuring. See Roubini/Setser (2004) for an overview of the various potential collective action problems.

6 An overview of the policy discussions on how to make sovereign debt restructuring processes more orderly is provided by Rieffel (2003) and Helleiner (2009). For an assessment by the Banque de France of the development of the Principles, see Couillault/Weber (2003) and Weber (2005). The financial industry perspective can be found in IIF (2008a).

7 See IMF (2003) and Hagan (2005) for further information on the SDRM and its rationale.

8 CACs usually include majority restructuring provisions that allow a required majority of bondholders to agree the terms of a restructuring agreement, as well as majority enforcement provisions that allow the required majority to prevent a minority from initiating litigation during negotiations on debt restructuring.

9 Discussions at that time on establishing the SDRM most probably resulted in increased support from the private sector for the use of CACs. See, e.g. Eichengreen et al. (2003), p. 9.

government assumed the role of an icebreaker and in February 2003 issued the first emerging market bond under New York law that contained a CAC, many other countries followed Mexico's example,[10] and today CACs are a standard provision in international bonds.[11] It is worth underlining that, contrary to earlier concerns and confirmed by empirical evidence, CACs have not significantly affected the price of the bonds or the levels of subscription.[12]

The Principles are the second leg of the market-based approach. They were jointly agreed between sovereign debtors and private creditors in autumn 2004.[13] The Principles are voluntary and non-binding rules that seek to guide and structure cooperative actions of sovereign debtors and their private creditors both during normal times as well as periods of financial distress. More specifically, they aim to foster transparency and the timely flow of information between debtors and creditors and to ensure close debtor-creditor dialogue and cooperation to avoid restructuring. Further, when debt restructuring becomes inevitable, the Principles' objective is to facilitate a voluntary process of debt restructuring based on good faith and ensure the absence of unfair discrimination among affected creditors (see Section 2.2 for a more in-depth description of the content of the Principles). As far as their design features are concerned, the Principles are strictly voluntary, market based and applied on a case-by-case basis.

The seed of the Principles was planted in 2001 when Jean-Claude Trichet, then Governor of the Banque de France, floated the idea of devising a code of conduct on sovereign debt restructuring, to be embraced by the public as well as the private sector. He followed up on this idea and made an official proposal for such a code at the IMF Annual Meetings in 2002 (Table 1). Since then, efforts were stepped up both on the part of the public as well as the private sector, most notably the IIF together with other financial industry associations, to operationalise the concept.

Among the international institutions and forums that have encouraged and supported the development of the Principles – and its predecessor, the code of conduct – the group of G20 finance ministers and central bank governors (hereafter G20) stands out as a major contributor. The G20 has been closely involved in the development of the Principles from the start and, thus not surprisingly, first expressed its backing for further work in its New Delhi Communiqué in November 2002. Two years later in its Berlin Communiqué in autumn 2004, the G20 welcomed the Principles and conveyed its general support. Since then, various communiqués of G20 finance ministers and central bank governors have welcomed the efforts undertaken by sovereign debtors and their private creditors to implement the Principles. The well-established and solid link between the G20 and the Principles is strengthened by the fact that several policymakers who represent their countries in meetings of G20 finance ministers and central bank governors are also members of the Group of Trustees of the Principles.

The IMF has also expressed support for the Principles although, like the G10, it was not involved in their establishment.[14] In several of its communiqués, the Fund's International Monetary and Financial Committee (IMFC) stated that it looked forward to the work on the code/Principles and encouraged efforts to improve them further. Moreover, IMF management and senior staff have on various occasions welcomed implementation of the Principles. An institutional tie has been created between the Principles and the Fund since IMF representatives attend meetings of the Principles

10 One important motivation behind the Mexican Government's initiative, apart from pressure from the United States, was to avoid the establishment of the SDRM (see quotes from Guillermo Ortiz in Helleiner (2009)).

11 As a result, the share of outstanding emerging market sovereign bonds including CACs has continued to increase and, according to IMF staff estimates, reached at least 66 percent of the total outstanding stock of emerging market sovereign bonds in August 2007.

12 See, e.g. IMF (2005), p. 3.

13 See IIF (2005a).

14 According to the IMF, it "*has left [the] specification [of the Principles] to sovereign debtors and their creditors, since the effectiveness of voluntary rules hinges critically on their acceptability to the affected parties*" (IMF (2005)).

Table 1 The history of the Principles – from early ideas to final agreement and implementation

Year	Event
2001	Trichet floated the idea of a code of conduct at a meeting of the Bretton Woods Committee.
2002	Trichet proposed a code of conduct at the IMF Annual Meetings. (September)
	In their New Delhi Communiqué, G20 ministers and governors "*support further work by the international community, in consultation with debtors and creditors, on comprehensive and market compatible approaches to crisis resolution, including … a code of good practices*". (November)
2003	In the progress report on implementing the G7 action plan, annexed to the statement of G7 ministers and governors, it is noted that "*in the light of growing interest in exploring a voluntary 'code of good conduct', and since good investor relations are key to timely, orderly debt restructurings, we have instructed our officials to prepare a report, in consultation with issuers and the private sector, on these issues by our Fall meeting*". (April)
	In its Communiqué, the IMFC "*welcomes recent initiatives to formulate a voluntary code of conduct for debtors and their creditors, which will improve the restructuring process, and encourages the IMF to contribute to this work*". (April)
	In their Dubai statement, G7 ministers and governors "*look forward to further work on the code of conduct …*". (September)
	In its Dubai Communiqué, the IMFC "*looks forward to the efforts led by sovereign debtors and private creditors to develop a voluntary Code of Conduct, and encourages the IMF to continue to contribute to this work*". (September)
	In their Morelia Communiqué, G20 ministers and governors, "*with a view to promote the development of a workable code of conduct, … encourage an inclusive group of issuers and market participants to engage in further discussions, with G20 members participating on a voluntary basis*". (October)
2004	In its Communiqué, the IMFC "*also encourages sovereign debtors and private creditors to continue their work on a voluntary Code of Conduct*". (April)
	In its Communiqué, the IMFC "*notes recent initiatives aimed at achieving a broad consensus between sovereign issuers and their creditors on voluntary principles for emerging markets' crisis management and debt restructuring*". (October)
	Announcement of the Principles (on the eve of the G20 meeting in Berlin). (November)
	In their Berlin Communiqué, G20 ministers and governors "*welcomed the results achieved between issuing countries and private-sector participants on Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets. Such principles, which we generally support, provide a good basis for strengthening crisis prevention and enhancing predictability of crisis management now, and as they further develop in future*". (November)
2005	In its Communiqué, the IMFC "*notes the 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets' being developed by a number of sovereign issuers and the investor community, and encourages further efforts to improve the Principles aimed at achieving a broad consensus*". (April)
	In its Communiqué, the IMFC "*welcomes … the efforts by emerging market issuers and private sector creditors to broaden the consensus on the 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*". (September)
	In their Xianghe Communiqué, G20 ministers and governors "*welcome the efforts by borrowing countries and private-sector creditors to broaden the consensus on the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, which could contribute to strengthening crisis prevention and enhancing predictability of crisis management*". (October)
2006	Inaugural meeting of the Group of Trustees of the Principles, Singapore. (September)
	In their Melbourne Communiqué, G20 ministers and governors "*welcomed ongoing efforts by a growing number of borrowing countries and private-sector creditors on the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets to improve financial stability and enhance market access of emerging market economies*". (November)
2007	Second annual meeting of the Group of Trustees of the Principles, Washington DC. (October)
2008	Third annual meeting of the Group of Trustees of the Principles, Washington DC. (October)

Consultative Group in an observer capacity (see Section 2.3 below on the governance structure of the Principles' implementation process).

Finally, the Principles have received the backing of Paris Club creditors. At various annual meetings between representatives from the private sector and Paris Club creditors, the latter

reiterated their support for the Principles.[15] Furthermore, as the current Chairman of the Paris Club is a member of the Group of Trustees, a direct link has been established between the Paris Club and the Principles.

2.2 THE CONTENT OF THE PRINCIPLES

The Principles rest on four pillars: (i) transparency and timely flow of information; (ii) close debtor-creditor dialogue and cooperation to avoid restructuring; (iii) "good faith" actions during debt restructuring and (iv) fair treatment of all parties.[16]

- *Transparency and timely flow of information*. The Principles call on issuers to keep creditors appropriately informed about their economic and financial situation. More specific disclosure practices are to be implemented in cases of debt restructuring where the debtor should also provide more detailed information on its external financial obligations and economic policies as well as on agreements reached with other creditors, the IMF and the Paris Club.

- *Close debtor-creditor dialogue and cooperation to avoid restructuring*. The Principles recommend that a regular dialogue be held between debtors and creditors to facilitate the flow of information and data on economic and financial policies and performance. In this regard, the Principles suggest best practices for investor relations and see merit in establishing investor relations programmes (IRPs). Such IRPs facilitate consultation between debtors and creditors on market-based approaches to debt-servicing problems. Moreover, the Principles urge creditors to consider appropriate requests for the voluntary and temporary maintenance of trade and interbank advances, and/or the rollover of short-term maturities on public and private sector obligations. In this context, commitments by debtors to a strong adjustment programme, continued interest payments on interbank advances and service of other debt are regarded as impacting positively on the response by creditors.

- *Good faith actions*. In cases of debt restructuring, the Principles call on debtors and creditors to conduct a restructuring process that is voluntary and based on good faith. They note that "*such a process is based on sound policies that seek to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance of payments sustainability in the medium term*". During a debt restructuring process, the Principles recommend timely good faith negotiations by debtors and creditors and call upon the IMF to adhere to its lending into arrears (LIA) policy that requires good faith negotiations to take place as a criterion for the Fund to support a distressed debtor.[17] While the appropriate format and role of negotiation vehicles such as creditor committees should be determined flexibly and on a case-by-case basis, negotiations with a creditor committee should take place early in the event of default. Finally, the Principles urge debtors to resume, to the extent feasible, partial debt service as a sign of good faith and to resume full payment of the principal and interest as conditions allow.

- *Fair treatment*. The Principles request sovereign debtors to avoid unfair discrimination among its creditors. Debtors

15 See IIF (2005b, 2006b, 2007c).

16 See IIF (2005a).

17 According to this policy, the Fund undertakes lending into sovereign arrears to private creditors in cases where IMF support is considered key for the successful implementation of the member's adjustment programme, and the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors. The IMF's judgement about members' good faith efforts is guided by the following principles. First, when a member has concluded that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete. Second, the member should share relevant, non-confidential information with all creditors on a timely basis. Third, the member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments (IMF (2002)).

should therefore seek a rescheduling from all official bilateral creditors. Credits such as short-term trade-related facilities and interbank advances should be excluded from the restructuring agreement.

In all, by formulating guidelines to facilitate cooperative interactions between sovereign debtors and their private creditors, the Principles serve as a mechanism for crisis containment and resolution and are also relevant for crisis prevention. While improved debtor-creditor communication and enhanced transparency aimed to foster information-sharing are highly relevant measures to ensure a predictable and orderly debt restructuring process, they are equally important in times of financial tranquillity as a first line of defence against the emergence of a debt crisis.

2.3 THE PRINCIPLES' IMPLEMENTATION PROCESS

While the Principles were announced in autumn 2004, the process of their implementation started only in late 2005 when a light governance structure was put in place to assess the extent to which the various parties adhere to the Principles. The Principles Consultative Group (PCG), which currently consists of 24 finance ministry and central bank officials from emerging markets and senior representatives of the private financial community, constitutes a key component in this process. With technical support from the IIF, the PCG considers country cases and provides feedback and suggestions to country authorities and creditors on how to comply with the Principles. The PCG also examines whether the Principles remain relevant or require amendment. The Group of Trustees of the Principles (GoT), meeting once a year in the margins of the IMF Annual Meetings, is mandated to provide overall guidance for the implementation of the Principles and to make proposals for their eventual modification. The GoT is comprised of 30 senior leaders in global finance from both the private and the public sector and is jointly chaired by Jean-Claude Trichet (President of the European Central Bank), Henrique de Campos Meirelles (Governor of the Banco Central do Brasil) and Toshihiko Fukui[18] (former Governor of the Bank of Japan) (Chart 1).

18 He took over from Toyoo Gyohten, former Japanese Vice Minister for Finance, who held that position until October 2008.

Chart 1 The governance structure of the Principles' implementation process

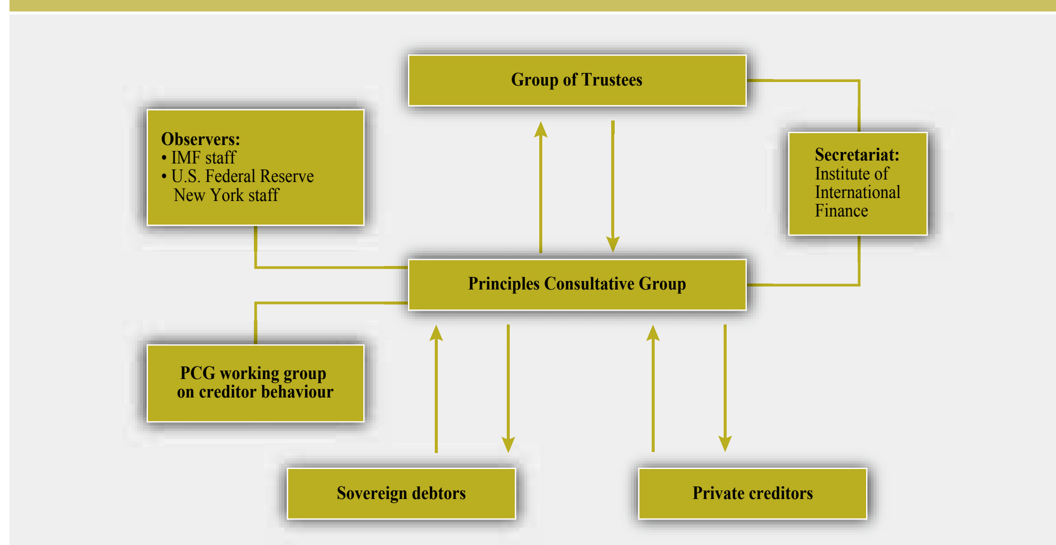


Table 2 Implementation of the Principles

Countries under review	Recommendations
Brazil, Dominican Republic, Indonesia, Mexico, Morocco, Peru, Philippines, South Africa, South Korea, Turkey	√ Bolstering investor relations and transparency practices
Hungary	√ Improving fiscal reporting and transparency and strengthening commitment to sound fiscal policy
Belize, Congo (Brazzaville), Dominican Republic, Grenada	√ Guiding debt restructurings
Nicaragua	√ Guiding external debt buy-back

Source: IIF (2006a, 2007a, 2007d, 2008b).

The current state of implementation of the Principles is laid out in the annual reports that are prepared by the PCG.[19] These reports were submitted to the GoT and welcomed, though not endorsed, by the latter at its annual meetings in autumn 2006, 2007 and 2008 respectively.[20] In its three years of operation, the PCG dealt with three main sets of issues. First, it reviewed more than a dozen country cases with respect to implementation of the Principles' recommendations and engaged in a dialogue with country authorities. Second, the PCG reflected on how it can assess actions by creditors in light of the Principles and their crisis prevention and crisis resolution aspects. And third, it explored how to integrate the Principles into the international policy dialogue and the marketplace.

(i) ***Review of country issues***. The PCG assessed, and provided feedback to the authorities on, the quality and effectiveness of country communication with investors as well as their data provision and transparency. Moreover, it reviewed the economic policies of several debtor countries and considered some debt restructuring issues. The selection of countries examined by the PCG is determined on the basis of a consultation by the IIF with members of the PCG as well as other market participants.[21] According to the implementation reports, the views conveyed by the PCG to the country authorities met with positive responses in a number of cases. Further, the PCG found that application of the Principles in the debt restructuring and buy-back cases under review had promoted the orderly resolution of the crises as the authorities and private creditors had adopted cooperative, transparent and market-based approaches (Table 2).[22]

Among the debt restructuring processes that were based on a strategy explicitly aiming to be consistent with the Principles was, as mentioned in the table above, the one of Belize in 2006-07. The authorities had engaged their creditors in an open and intensive dialogue and ensured transparency in the dissemination of economic and financial data and projections. Further, Belize had sought guidance from the IMF and the Inter-American Development Bank (IDB) in designing its macroeconomic adjustment strategy and received the backing of the IMF for its debt exchange offer.[23] What is noteworthy is that for the first time in more than 70 years collective

19 IIF (2006a, 2007d, 2008b).
20 IIF (2006c, 2007e).
21 IIF (2007d), p.3.
22 Until October 2008, the PCG and the GoT did not publish any of the PCG's country assessments and discussions with the authorities. Country-specific information on implementation of the Principles is nevertheless contained in various IIF publications, such as the IIF policy letters to the Chairman of the IMF's IMFC and the summaries prepared by the IIF of the meetings of private sector representatives with Paris Club creditors.
23 In a letter to the international financial community, the Managing Director of the IMF stressed that "*high participation by private creditors in the debt exchange offer … would help support orderly macroeconomic adjustment, restore fiscal and external sustainability, and establish the conditions for strong economic growth*" (see IMF (2006)).

action clauses were used to amend the payment terms of a sovereign bond governed by New York law. In sum, application of the Principles had led to an orderly and highly successful debt restructuring process – with a high participation level of creditors (> 98%) – following completion of which Standard & Poor's raised Belize's credit rating to B (see the box below for further information).

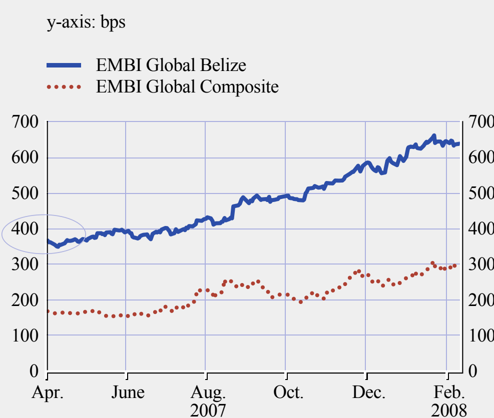
A case study of Principles' implementation: Belize

In the face of significant fiscal and balance of payments financing gaps, Belize sought a cooperative and orderly debt restructuring with its private creditors in 2006. The debt exchange offer that was launched on 18 December 2006 and closed on 20 February 2007 resulted in 97% of the holders of affected debt exchanging their claims. In the case of one bond where 87.3% of holders tendered their claims, restructuring terms were applied to the untendered amounts, increasing the final participation level of the debt restructuring to over 98%.[1] As a result, the debt restructuring led to a 21% debt reduction in net present value (NPV) terms. The new 22-year bond issued by the Belizean authorities, which consolidates most of the external debt owed to commercial creditors, has been included in the JP Morgan Emerging Markets Bond Index Global (EMBI Global). It is worth highlighting that following the debt exchange, first, the price of the new bond strengthened substantially and, second, Belize experienced an initial slight reduction in spreads (see Charts below).

Chart A Bond prices before and after the debt exchange

Source: Bloomberg.

Chart B EMBI spread on Belizean bonds after the debt exchange and EMBI spread



Source: JP Morgan.

1 More detailed information on the debt exchange is provided by the IMF in its latest staff report on the 2008 Article IV consultation with Belize (see IMF (2008)) and by the law firm advising the Belizean authorities during the process (see Allatt (2007)). See also Buchheit/Karpinski (2007).

(ii) ***Assessment of creditor behaviour***. The PCG also devoted attention to how to assess actions by creditors and investors in light of the Principles. To that end and to ensure that the implementation process strike a balance between debtor and creditor focus, the PCG working group on creditor behaviour was set up in late 2006 to determine the extent to which risk management and investment decisions by creditors and investors are guided by the Principles. Moreover, as far as the crisis containment and resolution aspects of the Principles are concerned, the working group – jointly with the IIF working group on crisis resolution – has provided clarifications and suggestions for improving a number of elements of the Principles, most notably good faith negotiations and the role of creditor committees in the Principles as well as best practice principles for creditor committees.

As regards the notion of good faith negotiations, the PCG working group considered whether this concept needed to be defined in more precise terms. As mentioned previously, although actions conducted in good faith are one of the four pillars of the Principles, the concept has been framed in rather general terms and remains somewhat vague.[24] While some observers do see merit in the Principles offering more specific guidance on good faith negotiations,[25] the PCG working group addressed this issue in 2007 and concluded that a certain degree of imprecision ought to be retained. It noted that it is "*neither wise nor practical to seek an exhaustive set of criteria to evaluate this principle*". Rather, it suggests pursuing a pragmatic approach whereby "*any participant in the negotiation process [is] to indicate when it believes that actions of another party have not been conducted in good faith*".[26]

In its assessment of the role of creditor committees under the Principles, the working group finds that in some past debt restructuring cases, authorities, in the view of creditors, have not always been in full compliance with the Principles. This relates, for instance, to the refusal by debtors to negotiate with ad hoc creditor committees. While the Principles do recommend the use of creditor committees when a debtor defaults on its debt to private creditors and investors, the PCG working group sees merit in refining, in the context of a possible future update of the Principles, the conditions under which creditor committees are first-best vehicles for debt restructuring. More specifically, in view of the comparability of treatment principle,[27] a committee approach is considered to be preferable in cases where a restructuring is mandated by the Paris Club.

The PCG working group developed best practice principles for the formation and operation of creditor committees, which aim to make creditor committees more acceptable to issuers and to protect the rights of creditors and investors. These principles cover a number of committee-related issues, such as the importance of cooperation and trust; the diversity of the creditor community; the speed of setting up a committee and the significance of confidentiality.

24 The Principles call on creditors and debtors to "*engage in a restructuring process that is voluntary and based on good faith. Such a process is based on sound policies that seek to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance of payments sustainability in the medium term*". The Principles add that "*debtors and creditors agree that timely good faith negotiations are the preferred course of action toward these goals, potentially limiting litigation risk*".

25 See, e.g. Bedford et al. (2005) and Weber (2005).

26 For an assessment of the concept of good faith as an evolving norm, see Thomas/García-Fronti (2007).

27 The comparability of treatment principle of the Paris Club, seeking to ensure a balanced treatment among all external creditors of the debtor country, requires a debtor country to agree with both its non-Paris Club sovereign creditors and private creditors a rescheduling of its debt on terms comparable to the Paris Club's own agreement.

(iii) ***Integration of the Principles into the international policy dialogue as well as the marketplace***. In the view of the PCG, consideration could be given to fostering relations between the Principles and the IMF, e.g. through exploring synergies between the PCG's discussions and the Fund's policy advice, improving implementation of the Fund's data standards by providing input in areas that are important to investors, and discussing the links between the Principles and the Fund's lending into arrears policy. Also, thought could be given to exploring further the link between the Principles and the Paris Club, in particular the comparability of treatment principle. Moreover, to increase awareness of the Principles and foster support, the PCG will consider the extent to which those elements of its work that are not made public, e.g. its assessments and discussions with authorities, could be publicly released. The PCG will also look into whether there is merit in encouraging rating agencies to consider implementation of the Principles in their assessment of a country's creditworthiness.

3 ASSESSMENT

Why have the Principles been successful in making the international financial system more resilient to sovereign debt crises and turmoil? How do the Principles differ from other attempts at reform? And why is it that the Principles have not only survived but even progressed as a mechanism for crisis prevention and crisis resolution? This section addresses these questions by analysing the fundamental characteristics that define the Principles.

More specifically, having considered the historical development of the Principles as well as their content and current state of implementation, the section examines the specific design features of the Principles and analyses some issues related to their implementation. It starts by appraising the Principles as the product of a transnational PPP and sheds some light on why sovereign debtors and private creditors chose a soft mode of governance to order their relations. Thereafter, a set of differentiated criteria of legalisation is applied to gain insight into how the Principles have evolved over time in the continuum of soft law and hard law. Further, the reputational effects stemming from Principles' (non-)implementation are assessed for different types of sovereign debtor. Finally, some thought is given to the possible evolution of the implementation process going forward.

3.1 THE PRINCIPLES AS THE PRODUCT OF A TRANSNATIONAL PUBLIC-PRIVATE PARTNERSHIP

Transnational PPPs are institutionalised arrangements between state and non-state actors across national boundaries. They play an increasingly important role as tools of governance in the global financial system.[28] A particular type of this hybrid form of governance is co-regulation where state and non-state actors are equal partners in creating and implementing rules and standards and monitoring compliance.[29] Owing to these features, co-regulation fosters ownership of the parties involved and facilitates commitment and compliance. The Principles, being a joint product of sovereign debtors and their private creditors and investors, are a good example of the outcome of a transnational PPP. It may be noted that, while in the not-too-distant past state actors used to be the only key players in international financial rulemaking, the emergence of innovative instruments such as the Principles confirms the relevance of private actors in the governance of the global financial system.[30]

While a transnational PPP is an attractive governance tool for debtors and creditors, a broader question relates to the incentives for state and non-state actors to join forces in the first place and agree on establishing an instrument that serves as a mechanism for crisis prevention and resolution, and hence delivers the public good of global financial stability. As touched upon previously, looking back at the discussions earlier this decade on ways to strengthen the international financial architecture, one of the main reasons why emerging market sovereign debtors and private creditors supported the Principles was the broad joint dislike for the statutory approach to sovereign debt restructuring in the form of the SDRM. Indeed, the shadow of hierarchy or the perceived threat of government regulation in the area of sovereign debt restructuring helped pave the way for the Principles as a specific result of joint governance.[31]

3.2 THE PRINCIPLES AS A SOFT MODE OF GOVERNANCE

Apart from being the product of a transnational PPP, the Principles are strictly voluntary and

28 See, e.g. Andonova (2006) on the increasing importance of transnational PPPs and Schäferhoff et al. (2007) for a useful survey of the current literature on this specific tool of governance.

29 Co-regulation is one specific type of PPP in the broad continuum of PPPs. For an overview of the range of different PPPs, see Börzel/Risse (2005), p. 200.

30 An overview of the involvement of the private sector in global financial regulation can be found in Mosley (2005) and Drezner (2007).

31 The shadow of hierarchy, i.e. legislative threats or incentives, may indeed serve as a catalyst for successful interactions between private and public actors, as argued, e.g. by Börzel/Risse (2005).

non-binding guidelines and thus represent not a mandatory approach, but a soft mode of governance. This broad classification is in line with standard analyses of institutional arrangements and their features, which are usually based on a binary distinction between soft (non-binding) and hard (binding) law.[32] Such a simple binary classification is not sufficient, however, to allow for a more detailed analysis as to why sovereign debtors and their private creditors and investors opted for the Principles as a very specific mode of governance to order their relations and to complement the policies and rules set by international institutions and forums in the area of crisis prevention and crisis resolution. For this reason, and to explore how the Principles have evolved over the last few years, some more finely differentiated assessment criteria are required.

A useful framework that permits a more nuanced perspective on the intermediate forms of soft and hard law is the concept of legalisation developed by Abbott et al. (2000) who classify soft law and hard law along a continuum of three independent dimensions of governance, namely obligation, precision and delegation. The dimension of obligation relates to the extent to which rule(s) and commitment(s) bind actors, ranging from non-legal norms on one end of the spectrum to legally binding rules on the other. With regard to the second dimension of legalisation, a rule that is precise spells out clearly and unambiguously objectives and instruments, with the two extreme forms being vague principles and precise, highly elaborated rules. The third dimension of legalisation pertains to the degree of authority that is delegated to third parties to implement agreements, provide dispute resolution and make rules. Delegated authority can vary from diplomacy, where the degree of delegation is lowest, to international organisations and courts, reflecting a high level of delegation. Taking these three dimensions together, Abbott et al. provide useful definitions of hard law and soft law: an institutional arrangement is considered to be hard law if it is characterised by legally binding obligations that are precise and by a delegated authority in charge of interpreting and implementing the law. A softening of law occurs when one or more of the three above-mentioned dimensions of governance are weakened.

Looking at the design features of the Principles through the lens of this framework, we proceed in two steps. First, we seek to identify the reasons as to why sovereign debtors and their private creditors and investors chose the specific legalised arrangement of the Principles. Second, we assess the evolution of the Principles in the continuum of soft and hard law.

3.2.1 THE BENEFITS OF THE SOFT LAW NATURE OF THE PRINCIPLES

To shed some light on the motivation behind the soft mode of governance of the Principles as one of their specific design features, it is useful to turn to the literature on international relations/international law, which highlights a number of benefits associated with soft law.[33] Among the key advantages identified are lower negotiating or contracting costs, limited sovereignty costs, its role as tool of compromise, the way soft law deals with uncertainty, and improved information flows. These benefits are also relevant in the context of the Principles and are reviewed in turn.

- *Lower negotiating/contracting costs*. Soft law, defined along the above-mentioned three dimensions of obligation, precision and delegation, facilitates cooperative agreements between different parties as it entails limited contracting costs and implies lower stakes for the parties involved. Looking at the Principles, the realm of soft law has indeed catalysed successful negotiations and interactions between sovereign debtors and private creditors and investors.

- *Lower sovereignty costs*. The institutional devices of soft law such as non-binding obligations, imprecise commitments and the absence of extensive delegation of powers promote cooperation and limit the sovereignty

32 See Friedrich (2008) for a more in-depth analysis of codes of conduct.

33 See, e.g. Abbott/Snidal (2000) as well as Trubek et al. (2006).

costs to the parties involved. In the context of the Principles, agreeing on a soft institutional arrangement reflected the interests of both debtors and creditors as they sought to avoid the perceived undesirable effects of a hard law solution in the form of the SDRM.

- *Tool of compromise*. With actors' preferences usually diverging on some of the issues under negotiation, soft legalisation constitutes an effective tool of compromise that allows the various parties to align commitments with their respective interests. In the case of the Principles, agreement was reached despite the fact that the preferences of debtors and creditors were naturally not congruent in all aspects of crisis prevention and crisis resolution.

- *Coping with uncertainty*. In dealing with the exigencies of uncertainty, the non-binding nature of soft law affords greater flexibility when agreeing on modifications to the institutional arrangement as circumstances change. Moreover, in the absence of precise standards on certain elements of a potential agreement, a soft law approach can be seen as preferable since it fosters cooperation. The soft law character of the Principles enabled agreement to be reached on clarifications and complements without formal legal changes (see the following section on how the Principles have evolved over the last few years). Moreover, the soft form of legalisation has proved useful given that some aspects of the Principles, such as the notion of good faith negotiations, are not defined in precise terms.

- *Improved information flows*. The use of soft legal instruments helps improve the flow of information between the various actors and enhances transparency. This is confirmed by the Principles and their governance structure, which provide debtors and creditors with a useful mechanism and forum for interaction to develop shared ideas, build trust and foster mutual learning from each other's experience.

In sum, by using soft law as the mode of legalising their relations, sovereign debtors and their private creditors and investors managed to agree on the Principles as a joint institutional approach to crisis prevention and crisis resolution. It is this specific design feature of the Principles that reflects the mutual interests of the various parties involved and hence facilitated agreement.

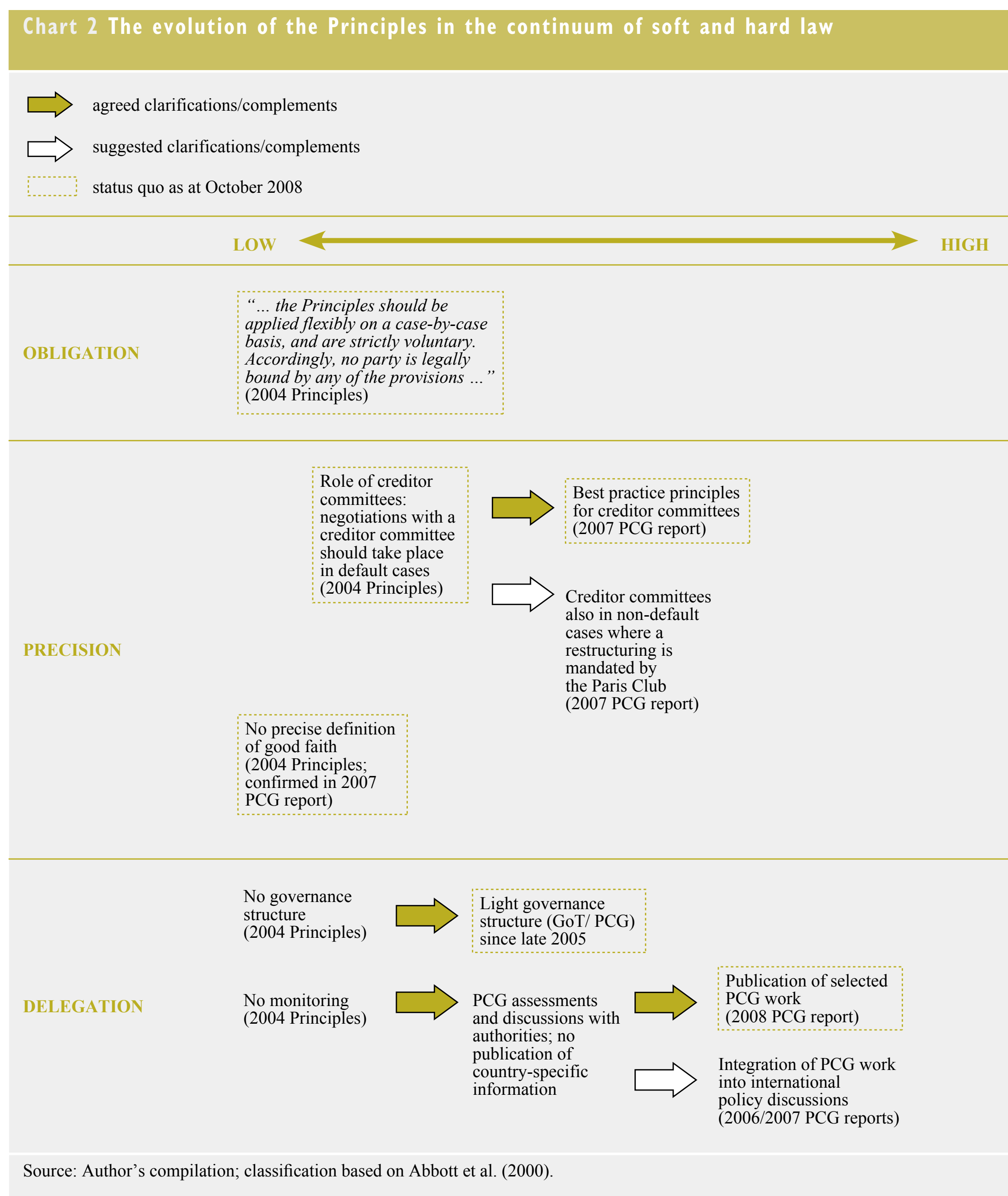
3.2.2 THE CHANGING DEGREE OF LEGALISATION OF THE PRINCIPLES

While the main body of the Principles has remained unchanged since its publication in spring 2005, a number of clarifications and complements have been agreed over the last few years. These pertain in particular to the role of creditor committees and the implementation process of the Principles. The framework created by Abbott et al. is a useful tool to assess these developments in light of the three dimensions of obligation, precision and delegation and to provide some insight into how the Principles have evolved in the continuum of soft and hard law.

As far as the level of obligation of the Principles is concerned, the assessment is simple since no changes have been made or suggested, meaning that this dimension of legalisation has remained unaltered: the Principles continue to be voluntary guidelines that are not legally binding (see Chart 2 for an overview).

With regard to the Principles' degree of precision, some clarifications and complements have been agreed that relate to the role of creditor committees. As mentioned previously, the best practice principles for the formation and operation of creditor committees that were agreed in 2007 provide operational guidance on a number of aspects. These relate to the notion of cooperation and trust, the diversity of the creditor community, the speed of setting up a committee and the significance of confidentiality. Taken together, these clarifications can be seen as a "hardening" of the Principles along the dimension of precision. A hardening would obviously also occur if agreement were reached

Chart 2 The evolution of the Principles in the continuum of soft and hard law



Source: Author's compilation; classification based on Abbott et al. (2000).

on the need to establish creditor committees[34] in non-default cases where a restructuring is mandated by the Paris Club or if a more precise definition of the concept of good faith negotiations were agreed.

As concerns the level of delegation of the Principles, some significant changes took place in late 2005 when the establishment of a light governance structure and the delegation of authority to the PCG and the GoT marked the beginning of the Principles' implementation process. Until that point in time, there had been no mechanism in place to monitor implementation of, and compliance with, the Principles. As far as the assessments

34 As was mentioned in Section 2.3, the Principles already provide a certain degree of precision with regard to creditor committees as they recommend the latter's use in cases where a debtor defaults on its debt to private creditors and investors.

by the PCG and its discussions with country authorities are concerned, in the first two years of implementation the parties to the Principles took the view that country-specific information would not be made public. This approach was changed in the third year of implementation when it was agreed that selected parts of the PCG assessments of a subset of the countries under review should be publicised. In sum, these agreed changes can be interpreted as a hardening of the Principles along the dimension of delegation. Any widening of this publication policy would of course imply a further hardening of the Principles. Also, weaving the Principles into the international policy dialogue and/or encouraging rating agencies to consider implementation of the Principles in their assessments of countries' creditworthiness would reduce their degree of softness.

In conclusion, any assessment of the evolution of the Principles that is solely based on a simple binary distinction between non-binding and binding law – hence looking only at their unchanged dimension of obligation – would be misleading as it would erroneously suggest that the overall degree of legalisation of the Principles has not changed. A richer and more nuanced appraisal is only possible if one moves beyond a one-dimensional assessment and considers also the dimensions of precision and delegation. Doing so reveals that since their launch in 2004, the Principles have in fact been hardened in terms of their precision and delegation and have thus shifted somewhat along the continuum of soft law and hard law towards the latter.

3.3 (NON-)IMPLEMENTATION OF THE PRINCIPLES AND THE REPUTATIONAL EFFECTS FOR SOVEREIGN DEBTORS

We observe that an increasing number of sovereign debtors and private creditors are implementing the Principles and acting in line with their recommendations. As mentioned previously, a key initial motivation for debtors and creditors to support this non-statutory or market-based approach, and hence the emergence of the CACs-cum-Principles framework, was to prevent the establishment of the SDRM that was generally seen to be non-desirable. As the Principles' implementation process advances, another motivation for sovereign debtors to subscribe to this mechanism is emerging, namely the signalling and reputational effects stemming from commitment and compliance. Indeed, signing up to and implementing the Principles is increasingly being regarded as a positive and credible signal to the international financial community that the respective debtor behaves as a responsible actor.

To explore in more detail the potential reputational effects associated with implementation of the Principles, we use the classification of reputation of debtor countries developed by Tomz (2007). According to Tomz, creditors and investors hold beliefs about whether a sovereign debtor will repay or default on its debt. These beliefs are formed on the basis of the information available to creditors and – irrespective of whether they correctly or incorrectly reflect the preferences of the debtor – represent the reputation of the debtor in financial markets and give rise to three types of debtor. Type I debtors are seen as having a strong preference for debt repayment and repay their debt regardless of whether conditions are favourable or adverse; type II debtors have the reputation of repaying in good times but not in bad times and type III debtors are expected to default in bad times and sometimes also in good times.[35] The reputation of a sovereign debtor, and hence its access to capital markets, changes if it acts contrary to its perceived type.

To use this reasoning in the context of the Principles, we adopt Tomz's categories of debtors but, while Tomz distinguishes between "repaying" and "defaulting" on external debt as the two actions that debtors can pursue, we differentiate between "implementing" and "not implementing" the Principles. Applying Tomz's framework allows for an assessment of the reputational effects of (non-)implementation

35 For further details on this classification and its relation to reputation, see Tomz (2007), pp. 16.

of the Principles depending on the type of debtor. A type I debtor who does not implement the Principles and whose actions are thus not in line with these guidelines will suffer a reputational loss that has an adverse bearing on its access to international capital markets. The same behaviour by a type III debtor will not have any reputational effect since this debtor acts as expected. Reputational gains, and thus improved access to capital markets, can be reaped by a type III debtor as well as a type II debtor in adverse conditions since these debtors, by implementing the Principles and hence pursuing a cooperative approach to crisis prevention and crisis resolution, take investors by surprise (Chart 3 provides an overview of the reputational changes induced by Principles' (non-)implementation).

What are the conclusions that can be drawn from this analysis? First, implementing the Principles can usually be expected to be in the self-interest of a sovereign debtor if implementation is perceived by market participants as a reputation-enhancing action, leading to improved capital market access. Second, implementation is also beneficial to the debtor in those cases where the negative reputational effects of non-implementation, and the ensuing impaired standing in capital markets, are avoided. In any case, private creditors and investors play an important role in advancing implementation of the Principles to the extent that they provide sovereign debtors with relevant reputational rewards and penalties.[36]

3.4 STRENGTHENING THE IMPLEMENTATION PROCESS OF THE PRINCIPLES

The Principles will continue to be a useful component of the international financial architecture owing to the relevance of private external creditors and their role in providing financing to emerging and developing economies. Indeed, in 2007 these countries in aggregate owed more than 50 percent of their long-run external debt to private creditors.[37] Since "blue sky conditions" in financial markets cannot be taken for granted and the global financial environment invariably changes over time, it is imperative to have in place sound mechanisms for crisis prevention and crisis resolution. To strengthen further the Principles' implementation process, a number of measures could be considered. First, it could be examined how to incorporate the Principles into the international policy dialogue by strengthening the links between the GoT/PCG and international policy forums and multilateral financial institutions. Second, more attention could be devoted to creditors and investors and their behaviour in the context of Principles' implementation. Finally, thought could be given on how to convey more information on the Principles and their implementation to the marketplace. Chart 4 provides an overview of these various measures.

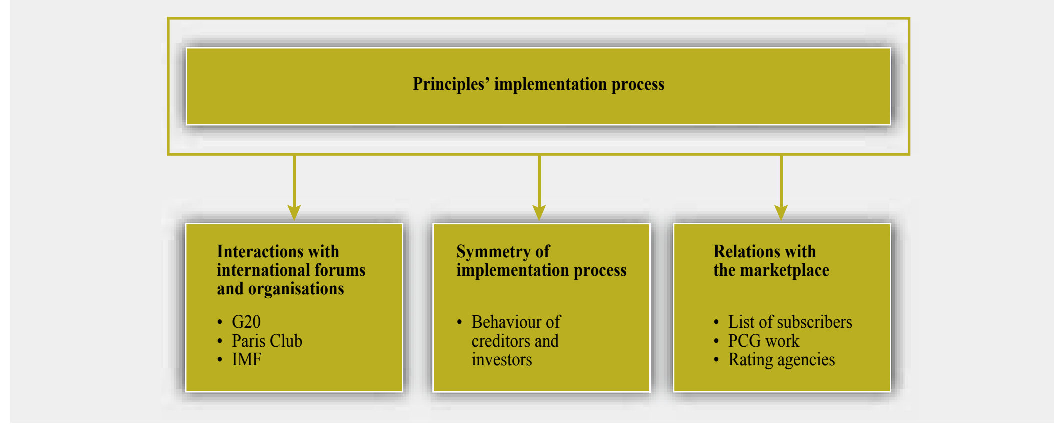
36 On the role of the private sector in fostering standards compliance by countries, see Vojta/Uzan (2003).
37 See World Bank (2008).

Chart 3 (Non-)implementation of the Principles and changes in reputation of a sovereign debtor

	Type I debtor		Type II debtor		Type III debtor	
	Favourable conditions	Adverse conditions	Favourable conditions	Adverse conditions	Favourable conditions	Adverse conditions
Implement Principles	0	0	0	⇧	⇧	⇧
Ignore Principles	⇩	⇩	⇩	0	0	0

Source: Tomz (2007), p. 19; author's classification of actions.

Chart 4 Potential measures to strengthen the Principles' implementation process



A first set of measures to strengthen the implementation process of the Principles pertains to the relations between the Principles and international forums and organisations. In this regard, relations with the G20, the Paris Club and the IMF are of particular relevance. There is clear merit in continued interaction between members of the Group of Trustees and the PCG and the Group of Twenty finance ministers and central bank governors given the latter's prominent role in the formation and implementation of the Principles. Events and conferences organised jointly by the GoT and the G20, such as the roundtables on international capital markets and emerging markets in April 2008 and 2009, are a useful way to raise further awareness of the Principles and enhance discussion on their implementation.

As far as links between the Principles and the Paris Club are concerned, initiating direct interactions between the Club and the bodies in charge of the Principles' implementation process could be useful if they focus on synergies between the Principles and the policies of the Club, identify areas of common interest and deepen mutual understanding. With Club creditors having expressed support for the Principles at their regular meetings with private sector representatives, an issue that could be explored further, and that is also mentioned in the PCG reports, is the relation between the Principles and the Club's principle of comparability of treatment. An exchange of views could be valuable since application of this principle has a bearing on the negotiations between the sovereign debtor and its private creditors. Another topic that is worth addressing is the recent practice by some non-Paris Club creditors of selling their claims on heavily indebted poor countries (HIPC) to private sector participants who then seek to fully recover these claims through legal action.[38]

Moreover, deepening the links between the GoT/PCG and the IMF would also be advantageous.[39] While IMF representatives already attend meetings of the PCG in an observer capacity, it could be considered to strengthen relations and seek more actively the cooperation of the Fund in implementing the Principles. One area on which dialogue could be sought – and which is also mentioned in the PCG reports – is the IMF's lending into arrears policy. The way the Fund applies this policy has an important impact on negotiations between a sovereign debtor and its private creditors and, as the IMF is likely to review its LIA policy at some stage, the PCG could be a useful forum

38 See Paris Club (2007).
39 For an assessment of the various elements of the Principles from an IMF perspective, see IMF (2005).

for participants to express their views on issues such as how the Fund specifies the financial parameters for a debt restructuring and how the good faith criterion is applied.

A second way to foster the implementation process of the Principles is to devote more attention to creditors and investors and their behaviour in the context of the Principles. As was mentioned in Section 2.3, the purpose of the PCG working group on creditor behaviour is precisely to look into this area. It seeks to develop methods for assessing the extent to which risk management and investment decisions by creditors and investors are guided by the Principles. Moreover, this working group, jointly with the IIF working group on crisis resolution, has produced best practices for the formation and operation of creditor committees. Efforts in this field could be stepped up further, and it is therefore welcome that the PCG in the future intends to review actions by creditors and investors. Such reviews could also usefully include the latter's adherence to key standards and codes. Doing so will not only broaden the implementation process, but will also help ensure a symmetric treatment of debtors and creditors/investors.

A third way that could be explored to strengthen the implementation process of the Principles relates to the communication of information on implementation to the marketplace. As previously discussed, only selected work and assessments of the PCG are made public, and it has therefore been suggested that the GoT and PCG publicise a list of debtor countries as well as of investors and creditors that subscribe to the Principles and implement their guidelines. More far-reaching suggestions would be to publish all PCG assessments or to encourage rating agencies to take information on (non-) implementation into account when gauging a country's creditworthiness. How should these ideas be judged? Those in favour cite the experience with publishing information on compliance with voluntary international standards and codes, such as the Fund's Special Data Dissemination Standard (SDDS), which shows that subscribing countries are able to reap benefits in terms of lower borrowing costs.[40] Moreover, according to proponents, conveying information to the marketplace would also help increase peer pressure as well as market pressure on debtors, creditors and investors to comply with the Principles. If one were to follow this logic, there would seem to be merit in the GoT and PCG publishing all information on the implementation process. At the same time, caution is necessary as to the selection of information to be published, for two reasons at least. First, as we have seen, several elements of the Principles are phrased in rather vague terms. As a result, assessing compliance is not a simple matter, but requires inevitably a certain degree of judgement on the part of the PCG. Second, as to the PCG's reviews of the economic policies of debtor countries, these assessments may at times deviate in some respect from those prepared by the IMF. Publication may therefore entail the potential risk of confusing market participants, in particular in times of financial stress. That said, the PCG is of course not the only channel through which information on compliance with the Principles can be communicated to the marketplace. Indeed, debtors and creditors themselves are free to do so – the release of information by the Belizean authorities in the course of their debt restructuring is a case in point.

40 See, e.g. the empirical studies by Cady (2004), Christofides et al. (2003) and Glennerster/Yongseok (2003).

4 THE PRINCIPLES AND POSSIBLE LESSONS FOR THE CURRENT POLICY DEBATE ON CODES OF CONDUCT IN GLOBAL FINANCIAL REGULATION

Codes of conduct – be they developed by state actors, non-state actors or jointly by state and non-state actors – play a relevant role in the ongoing discussions on ways to strengthen the functioning of the global financial system. As far as initiatives by the public sector are concerned, while the Organisation for Economic Co-operation and Development (OECD) continues its work on best practices for countries that receive cross-border investments from sovereign wealth funds (SWFs), the International Working Group on SWFs presented its best practices for these funds in October 2008. The financial industry, e.g. the Institute of International Finance and the Counterparty Risk Management Policy Group (CRMPG III), has released its proposals for best practices.[41]

The various codes of conduct that are currently being established differ of course in many respects. The differences relate in particular to the actors involved in the creation of these codes as well as to their scope and the relevant addressees. The efforts of the financial industry can be classified as private self-regulation in the shadow of hierarchy that focus on recommendations for non-state actors such as commercial banks and hedge funds. By comparison, the initiatives by international organisations and governments with regard to SWFs are an example of public regulation targeted at state actors. In the case of the Principles, it is public-private co-regulation which seeks to guide and structure the behaviour of state and non-state actors.

Despite all of these differences, codes of conduct face the same key questions, namely how to foster their effectiveness despite their voluntary non-binding nature and how to reconcile general guidelines with the necessary specificity. A number of observers express doubts about the potential of non-binding codes to effectively influence the actions of their addressees and to trigger changes in behaviour that would not also take place in the absence of a code. Moreover, it is at times maintained that owing to their general nature, codes lack the specific guiding force that is indispensable to meaningfully steer the behaviour of state and non-state actors. In response to these concerns, it is worth recalling the experience with the Principles since, as we have seen, they have proved to be a successful and effective code of conduct in spite of their voluntary and non-binding nature. While not claiming that the specific design characteristics of the Principles are a silver bullet and can be copied *in toto*, their features can nevertheless provide some lessons when it comes to devising codes of conduct in international financial regulation.

One lesson that can be drawn is that a code of conduct will only be complied with if the addressees of the code regard it as being in their self-interest. As can be derived from experience with the Principles, with actors applying cost-benefit analyses when making a decision as to whether or not to abide by a voluntary non-binding code, it is crucial for the designers of such an instrument to ensure that the reputational effects associated with (non-)compliance are of sufficient size. Moreover, the shadow of hierarchy is a significant determinant encouraging actors to comply as they seek to avoid public regulation in the form of mandatory binding law. In any event, what appears to be a *sine qua non* in the absence of legally binding obligations is a mechanism through which actors' compliance with a code of conduct can be monitored or, using the terminology of the concept of modes of legalisation applied earlier, agreement on some "hardening" along the dimension of delegation.

Another lesson provided by the Principles relates to the issue of how to reconcile a code's general guidelines with the necessary specificity.

41 These latter initiatives by private sector bodies have been welcomed by the Financial Stability Forum which regards them as consistent with and complementary to its efforts (see Financial Stability Forum, 2008).

As we have seen, a code of conduct can usefully be adjusted over time by hardening it along the dimension of precision once experience is gained in its application. In so doing, an appropriate balance can be struck between the two competing features of generality and specificity.

In sum, the designers of codes of conduct in global financial governance face the difficult, albeit not intractable, task of finding an issue area-specific combination of dimensions of legalisation that reflects the interests of the creators and addressees of the code. In the end, state actors need to determine whether a code is sufficiently ambitious both in terms of its substance as well as its overall degree of legalisation or whether further steps in the form of mandatory binding law need to be taken. Once a code is established, its designers ought not to treat the position of the code in the continuum of soft law and hard law as permanently fixed. They should instead adapt it in light of the experience gained in its implementation and in view of a changing global financial environment.

5 CONCLUDING REMARKS

The Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, which have been jointly agreed between sovereign debtors and their private creditors, have proved to be an effective instrument for crisis prevention and crisis resolution in the international financial system. While a systematic assessment of the role of the Principles is only feasible once more experience is gained with their implementation, it is noteworthy that three years into the implementation process of the Principles an increasing number of sovereign debtors and private creditors act in line with their voluntary and non-binding recommendations. The Principles, which complement the policies and rules set by international institutions and forums as well as the CACs in international bond contracts, provide a useful forum for interaction that, by relaxing information constraints and promoting mutual trust, fosters collaborative approaches. Serving as a focal point that facilitates the convergence of the negotiating positions of debtors and creditors, they help develop a shared understanding and increase the predictability of actions of the various parties. As a result, the Principles contribute to improving overall transparency and risk management in the global financial system.

What is the Principles' formula for success and why is it that commitment to, and compliance with, the Principles is advancing? To answer these questions, it is necessary to take a closer look at their specific design features and characteristics. As we have described, sovereign debtors and their private creditors and investors – in the face of the perceived threat of government regulation in the area of sovereign debt restructuring, i.e. the creation of the SDRM – managed to agree on the Principles as tool of joint governance and in so doing resorted to soft law to order their relations. Reflecting the mutual interests of the parties involved, it is this very mode of governance and its related benefits that made it possible for state and non-state actors to join forces and pull together. Moreover, since their launch in 2004, steps have been taken to ensure the continuous usefulness of the Principles to sovereign debtors and private creditors by adapting them to the evolving interests of the parties concerned. As the application of a set of differentiated criteria of legalisation has shown, the Principles have been modified in terms of their precision and delegation, while their level of obligation has remained unaltered. This change in the combination of the dimensions of legalisation has led to a shift of the Principles along the continuum of soft law and hard law towards the latter. The committed parties hence do not take a Panglossian view of the Principles and their current state of implementation: a further fine-tuning of their degree of legalisation may well take place. In any case, progress in implementing the Principles makes it hard to deny the effectiveness of soft law, proving wrong those observers who regard hard law *per se* as the superior mode of governance.

Looking at further incentives for sovereign debtors to comply with the Principles, we have argued that implementing the Principles can usually be expected to be in the self-interest of a sovereign debtor if implementation is perceived by market participants as a reputation-enhancing action, leading to improved capital market access. Implementation could also be beneficial to the debtor in those cases where the negative reputational effects of non-implementation, and the ensuing impaired standing in capital markets, are avoided.

Going forward, a number of steps have been discussed to strengthen further the implementation process of the Principles. First, there is clear merit in incorporating the Principles into the international policy dialogue by strengthening the links between the GoT/PCG with international policy forums and multilateral financial institutions. Second, further investigation into the behaviour of creditors and investors in the context of implementation of the Principles is useful, not least to ensure a symmetric implementation process. As far as communication of information on Principles' implementation to the marketplace

is concerned, we have argued that, while publishing information is desirable, selecting the information to be published requires some caution. At the same time, individual debtors and creditors are of course free to decide whether and to what extent they wish to publicise information on their compliance with the Principles. Taken together, these steps are conducive to raising further awareness and support for the Principles and anchoring their implementation process, thereby helping put the Principles on a path towards becoming a market standard and increasing the resilience of the global financial system.

As regards possible lessons that could be drawn from the experience with the Principles as a successful and effective code of conduct for the current international policy debate on global financial regulation, we have argued that the incentive structure of a code as well as the reputational effects associated with compliance are important elements that should be borne in mind when designing such a tool. Moreover, we have made the case that it is crucial to strike an appropriate balance between a code's generality and its degree of specificity. As there is no blueprint for an optimal design of a code of conduct, getting the combination of obligation, precision and delegation "right" is a key challenge both when establishing the code as well as during its implementation phase. Only if this ongoing challenge is successfully met will the code maintain credibility and hence its relevance in the governance of the international financial system.

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