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A proposal for a new International Debt Framework (IDF) for the prevention and resolution of debt crisis in middle-income countries

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[*] Views expressed in the paper are those of the authors and not of the German Development Institute or the Friedrich Ebert Foundation

Executive summary

The lack of a comprehensive framework for sovereign debt restructuring not only generates significant costs but endangers the stability of the international financial system. In addition, collective action problems involved in the restructuring of sovereign bonds place an obstacle to an orderly and rapid restructuring. The case of Argentina presents a good example for difficulties a sovereign but also private sector stakeholders are facing in the absence of an orderly debt restructuring mechanism.

This paper outlines a possible approach for a new International Debt Framework (IDF) that presents a middle ground between a legally binding insolvency procedure and a voluntary code of conduct. Any comprehensive restructuring mechanism could only be successful if intergovernmental support and leadership by developed and developing countries would be guaranteed. Since the G20 meetings of finance ministers from developed and developing countries have proved to be a successful forum to analyze and to deal with instabilities of the international financial system we propose the G20 as the forum for the establishment of the IDF. To ensure predictability for international creditors the provision of a general set of principles such as the recent proposal for a code of conduct made by leading sovereign issuers of international bonds and leading private creditors is included in our proposal.

The IDF should have two functions: crises prevention and crisis resolution. Permanent debtor-creditor dialogues, the provision of transparency and information on emerging market debt markets are necessary to prevent crises. Under the new IDF this would be ensured through the creation of a permanent IDF-Secretariat. All stakeholders could nominate members for the IDF-Secretariat.

To resolve the situation of a financially distressed sovereign the facilitation of an orderly debt restructuring mechanism is necessary. The IDF Commission takes on this function and would comprise representatives from the debtor, private creditors, multilateral lenders and sovereign creditors. In contrast to the SDRM proposal of the IMF, the underlying framework for the IDF is not statutory. According to the proposal, the IDF Commission would aim for a coherent and comprehensive debt restructuring, propose the amount of necessary financial support and an economic adjustment path that could guarantee long-term debt sustainability.

1. Introduction

A series of financial crises in emerging markets since 1994 and the gradual expansion of middle-income countries' credit base with bonds have posed major challenges in resolving sovereign debt problems. These developments have opened the debate in the international community for a necessary new framework that recognizes that private and public creditors are equally involved in a debt restructuring process.

1.1 Shortcomings in the current system to restructure debt

In circumstances, in which a country's debt burden has become unsustainable, a country's debt has to be restructured. The problem with the existing ad-hoc machinery for debt restructuring on a case by case basis is that these processes are disorderly, delayed and inefficient which generates undue costs for both debtors and creditors and are a source of contagion for entire emerging markets. These costs include for example falling real output, increasing real interest rates and / or inflation rates etc.

The reasons for the delay of a restructuring process are manifold. While restructuring processes are often delayed due to great costs for sovereign debtors, the delay itself triggers enormous costs for both creditors and debtors. Other reasons for a delayed debt restructuring procedure are uncertainties about the restructuring process itself. An orderly debt restructuring mechanism, which is predictable and based on a general set of principles that are endorsed by creditors and debtors, would lead to an initiation of a restructuring process at an earlier stage.

Since there are large and heterogeneous creditor groups holding sovereign bonds there are serious coordination problems when it comes to a restructuring. These coordination problems associated with sovereign bond restructurings are greater than those involved in restructuring other debt instruments because creditor groups holding other debt instruments are not that heterogeneous. International bank loans, for example, are often held by banking syndicates consisting of a small number of large international banks. Collective action problems have, to date, made the cost of restructuring excessively high for debtors and creditors alike and are an important obstacle to a rapid recovery of a sovereign debtor. Three collective action problems play an important role in coordinating private creditors.[1]

- **The holdout problem**: A restructuring procedure that is acceptable to a majority of creditors can be blocked by a creditor minority (holdouts). As a result creditors have an incentive not to participate in the restructuring process and will wait until the debtor is in a better financial situation in order to enforce their claims in full after conclusion of the restructuring process.

- **The rush to the exit problem**: If creditors fear the risk of a financial crisis, they are likely seeking to sell their bonds immediately. From the perspective of an individual creditor this would be a rational decision, as they could secure a better price for their

[1] For an overview of collection action problems see Berensmann, K. (2003); Roubini (2002).

claims in comparison to other bondholders that are acting on a financially distressed sovereign debtor at a later stage.

- **The rush to the courthouse problem**: Individual bondholders have an incentive to take recourse to litigation to enforce their claims.

1.2 Procedures of the current system to restructure debt

New operational instruments need to be developed to solve international debt problems for middle income countries because existing instruments such as Collective Action Clauses (CACs) are not sufficient. CACs are not a comprehensive approach for the restructuring of sovereign foreign debt since they do not require adequate aggregation of different debt instruments (such as loans and bond issues).[2]

In the current discussion there are two further approaches: a voluntary approach - a code of conduct[3] and an international insolvency procedure. A code of conduct would only be effective if it would be binding and not only voluntary. A code of conduct could contribute to solving the collective action problems mentioned above, however, it cannot fully solve them. A code of conduct is not an instrument that could prevent the rush to the exit problem, does not protect against litigation by creditors and offers no additional safeguards against holdout behaviour.

An insolvency procedure such as the proposed Sovereign Debt Restructuring Mechanism (SDRM) of the IMF would provide a legal framework for dealing with over-indebted countries. It would not only make it possible for financially distressed sovereigns to engage in an orderly debt restructuring process with its creditors, furthermore, this approach could solve the three collective action problems outlined above. However, the SDRM was put on hold in April 2003 due to resistance by financial market investors and developing countries' governments. Most emerging markets' governments fear to lose access to international capital markets once such a procedure had been initiated.[4] One additional concern of the critics of the SDRM is that, as a major creditor, the IMF would not be a neutral party in the negotiations that the debtor country enters with other creditors.[5] Private sector creditors, in particular banks, generally rejected the SDRM approach because the procedure might increase debtor's moral hazard. In addition, not only the amendment to the IMF Articles of Agreement that would have been necessary for the implementation of the SDRM, moreover, the required translation of this new international insolvency procedure into national legislation was highly contested.[6]

[2] For an overview of instruments to restructure sovereign bonds as well as the advantages and disadvantages of CACs see Berensmann, K. (2003)
[3] The most important proposals on the formulation of a code of conduct are the Trichet proposal, one proposal of the private sector and one proposal of the private sector in coordination with leading sovereign issuers of international bonds. Banque de France (2003); EMTA et al. (2003); IIF (2004)
[4] See Filho (2003); Roubini / Setser (2003)
[5] Herman, B.(2003), p. 217
[6] See EMCA et al. (2003)

Even though intergovernmental consideration for an SDRM came to a halt, it is nevertheless important to acknowledge that the general idea for an international insolvency procedure is the only proposal so far that could be used to aggregate debt classes and to group debts within these classes.[7] This paper will outline the proposal for a new International Debt Framework (IDF) that could offer a solution between a legally binding SDRM and a voluntary code of conduct. It could be designed in a way that it would address coordination problems between debtors and creditors and serve as a substitute for existing ad hoc mechanisms such as the Paris Club which only deals with public debt and the London Club which only deals with private debt.

2. The present debt situation in emerging markets

In four emerging market countries belonging to the intergovernmental Group of 20 (G-20), debt sustainability is currently endangered. The World Bank classifies Argentina, Brazil, Indonesia and Turkey as severely indebted.[8] A country's external debt can be considered as unsustainable if the country is not able to meet all of its current and future debt-service payments without having to restructure its debt, and without endangering its prospects of economic growth.[9]

There are problems involved in identifying the "correct" indicators for assessing a given country's debt sustainability. The approach is to define a proper quotient for debt stocks or, alternatively, debt-service payments (numerator) expressed as a proportion to variables that reflect a country's potential repayment capacity (denominator); the latter may include, for example, gross domestic product (GDP), exports or government revenues.

Even assuming that the "correct" indicators are chosen, it is difficult to set the "correct" threshold values for a country's debt sustainability. In addition, it is difficult to identify one uniform threshold for all countries. Under the HIPC-Initiative, for example, a country's debt is regarded as unsustainable if a country's debt (net present value[10])-to-export ratio exceeds 150% or alternatively its debt stock (net present value) exceeds 250% of government revenues.

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[7] A history of ideas regarding international insolvency procedures can be found in Rogoff/ Zettelmeyer (2002)

[8] See World Bank (2005). For classifying countries as severely indebted the World Bank uses two criteria: the ratio of present value of debt service to gross national income (GNI) and the ratio of the present value of total debt service to exports. The first criteria need to be higher than 80% and the second criteria higher than 220%. However, these data are not available. Published debt indicators include total external debt to exports of goods and services or total external debt to gross national income, but no data of present value of debt service to gross national income (GNI) and the present value of total debt service to exports are available.

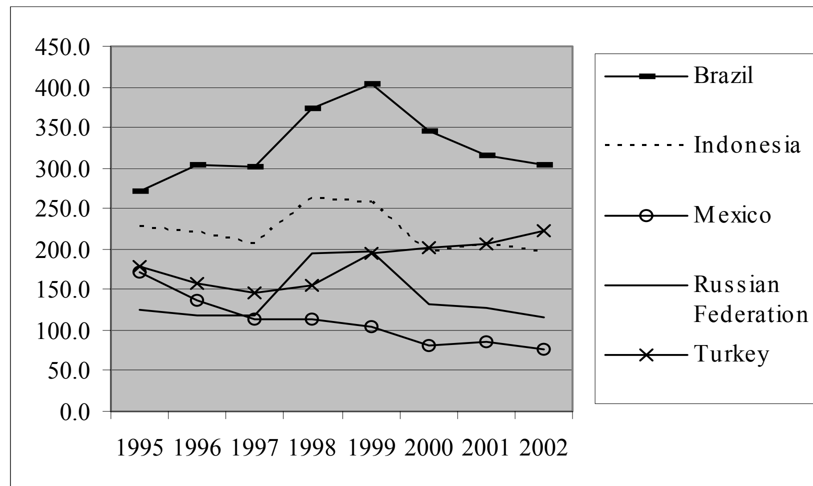
[9] See IMF / IDA (2001)

[10] Either the present value or the net present value (NPV) of debt stocks can be adopted. Since a certain share of external credit is provided on concessional terms, IMF and Word Bank used the net present which takes account of the degree of loan concessionality involved. The market interest rate is used to discount the sum of all future debt-service obligations (interest and redemption) down to their present value. In case the interest rate on a loan is below the commercial level, the net present value of a debt will be lower than its present value. The differential between these two variables is, finally, the grant component.

In 2002, debt to export ratio was in excess of 150% in three emerging markets: Brazil, Indonesia and Turkey (Figure 1). Since 1996 for Brazil this ratio was even double as high as the threshold defined under the HIPC-Initiative. It must be taken into account, however, that we used present values of debt stocks because net present values are not available. In Russia, the debt to export ratio has declined substantially since 1999.

Figure 1: Debt stock in terms of exports

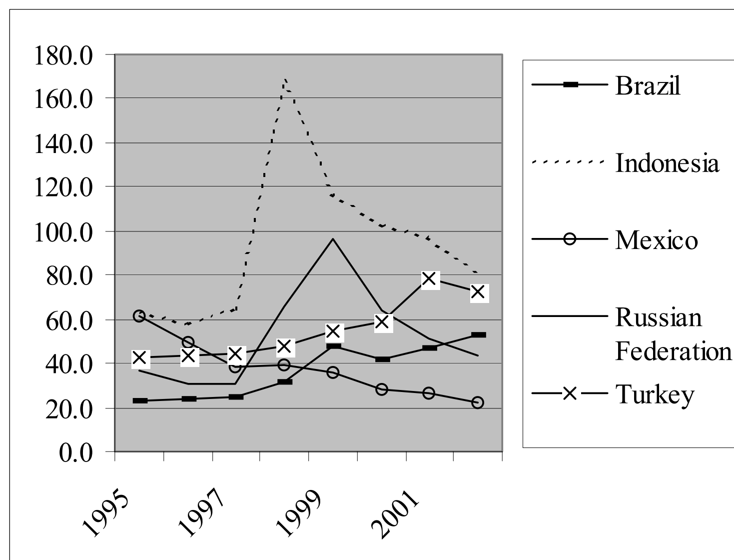
(in per cent)



Source: World Bank (2004), Global Development Finance

Debt sustainability can also be measured by using debt stocks as a proportion to Gross National Income (GNI). However, it is difficult to define a threshold for debt unsustainability, nevertheless, a debt to GNI ratio in excess of 50% may endanger debt sustainability. In Brazil, Indonesia and Turkey this ratio was above 50% in 2002. Moreover, in Brazil, this ratio has tended to increase (Figure 2).

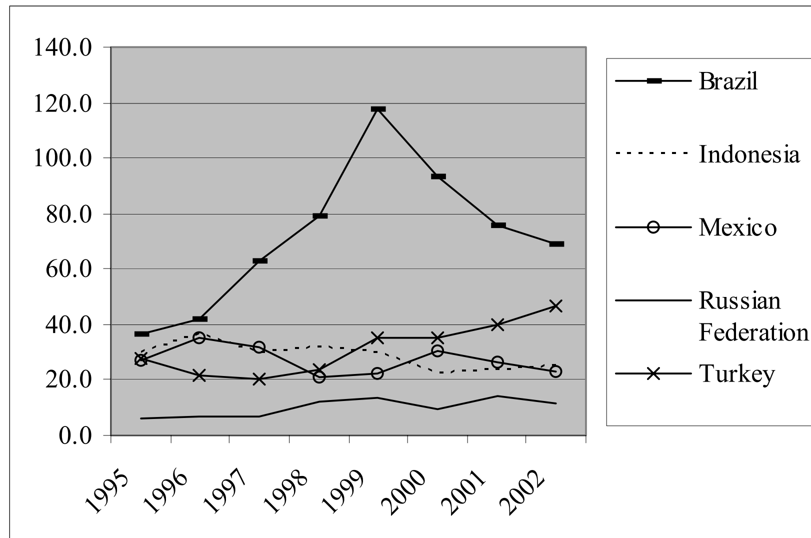
Figure 2: Debt stock in terms of GNI (Gross National Income) (in per cent**)**



Source: World Bank (2004), Global Development Finance

A debt service to export ratio above 30% indicates debt unsustainability (Figure 3). In Brazil, this ratio fluctuated between 37% and 118% during 1995 and 2002. This ratio was in excess of 30% in Turkey. In addition, since 1997 an upward trend can be identified in this country.

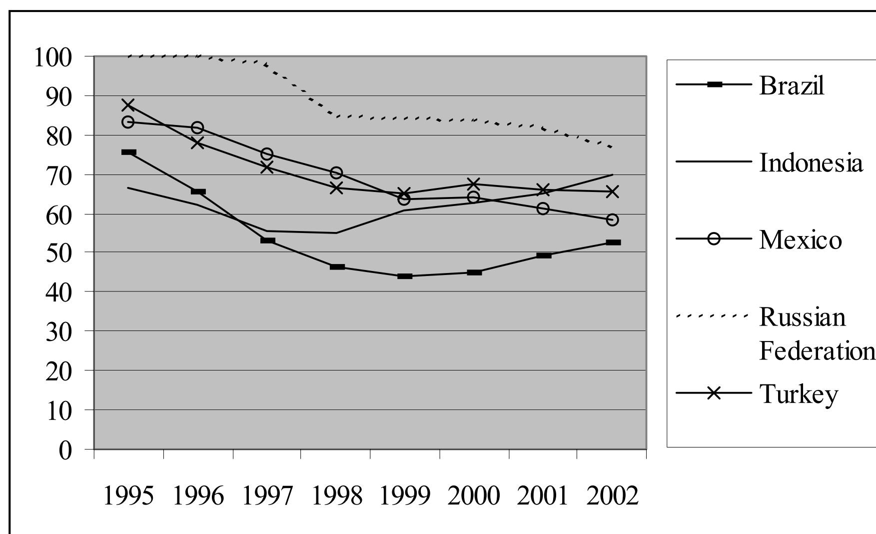
Figure 3: Debt services in terms of exports (in per cent)



Source: World Bank (2004), Global Development Finance

The structure of debt shows that private and public creditors are important in respective countries. However, official creditors' demands have exceeded those of private creditors. Figure 4 depicts debt outstanding to official creditors as a proportion to total debt . While in Russia debt signed by official creditors compared to private creditors have decreased substantially since 1997, in Indonesia official creditors have become more important since 1997.

Figure 4: Debt outstanding to official creditors (in per cent of total debt outstanding)



Source: World Bank (2004), Global Development Finance

3. Argentina's default and its negotiations with private bondholders

Many developing countries' governments have objected to an international debt restructuring mechanism fearing that it might delay restoration of access to capital markets and that it may impact other emerging market countries adversely. The largest sovereign debt default in contemporary history declared by Argentina in December 2001, provides a new template on what difficulties a sovereign but also private sector stakeholders are facing in the absence of an orderly debt restructuring mechanism. Regardless of how Argentina's debt is finally resolved, the Argentine crisis created an unprecedented long-term social and economic loss for its citizens and there is no denying the huge loss for public and private investors.[11]

3.1 The structure of Argentina's debt

Table 1: Argentina's Sovereign debt in June 2004 ($ Billions)

Debt Category	Amount	Percent
I. Performing debt	**84.7**	**43.3**
International Financial Institutions (IMF World Bank)	(32.7)	
BODENs*	(26.8)	
Guaranteed Loans	(12.9)	
Provincial Bonds	(10.0)	
Other	(2.3)	
II. Non-Performing Debt Not to be Restructured	**6.7**	**3.4**
Bilateral	(4.8)	
Commercial (mostly banks)	(1.4)	
Past Due Interest (PDI)	(0.5)	
III. Non Performing Debt to be Restructured	**104.1**	**53.3**
Bonds	(81.2)	
Past Due Interest (PDI through June 2004)	(22.9)	
Total Public Debt	**195.5**	

Data Source: Government of Argentina and Credit Suisse First Boston (for details see Hornbeck, 2004; pp. 2-4)

****National government bonds issued to compensate domestic banks and depositors for the peso devaluation.***

As of today and more than three years after Argentina's default, the country still must restructure over $100 billion owed to international bondholders, bilateral creditors and commercial banks (see Table 1). Except for the obligations to the IMF and World Bank almost all debt listed under category I (Table 1) is held by Argentines and has been restructured by conversion into devalued pesos. The Argentine government has not only reasoned that the service of all debt in category I is crucial for the functioning of the domestic

[11] See Hornbeck (2004)

banking system and the public sector (pension funds, health services etc.) but also acknowledged after some tough negotiations the preferred creditor status of the IMF and the World Bank.[12]

Given the fact that Argentina's debt owed to bilateral donors and commercial banks (category II) is rather small[13], the burden for the restructuring of Argentina's debt will fall on the country's private bondholders (category III). But negotiations with private bondholders have posed a complex and outright daunting challenge to the Argentine authorities. Argentine bonds were issued to more than 500,000 retail investors around the world and the government has to restructure 150 different bonds, issued in eight different jurisdictions and in seven different currencies.[14]

3.2 Negotiations with the private sector

Private investors have been outraged not only about the fact that they are expected to take the largest debt write down of all creditors, moreover, they were distressed by the refusal of Argentina to enter negotiations with its private bondholders for over 20 months after the crisis. That an immediate re-admittance to global capital markets is not necessarily a high priority for a defaulted government is best explained by James Carville: "Governments, keen to borrow on favorable terms, will go to great lengths to maintain their good standing in the capital markets. After a default, however, a government no longer has any standing to worry about. It has nothing left to loose."[15] As a matter of fact, the Argentine economy regained real economic growth in 2003 by 8.8% and by 7.0% in 2004 despite a de facto shut off from world capital markets.[16]

In September 2003 Argentina presented for the first time a unilateral offer to its bondholders that translated into a debt write down of 75% of eligible principal and 100% past-due interest payments. This proposal was not only immediately rejected by the groups organized to represent Argentine bondholders,[17] the degree of desired relief was in the order of more than 90% on a net present value basis, and had no parallel in Argentina's financial history.[18] After earnest negotiations with bondholder groups in the first half of 2004, Argentina continued to take a tough stance with its creditors by insisting on a level of debt relief that according to its own estimates should ensure that its debt service will not exceed a primary fiscal effort[19] of

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[12] In other words, all debt ($32.7 Billion) owed to the International Financial Institutions is not subject to restructuring and will be serviced in full.
[13] Debt of category II is currently not being serviced and could be at any time restructured by existing ad-hoc machinery such as the Paris and London Club.
[14] See Guillermo Nielson, Secretary of Finance, Argentina (2004)
[15] See The Economist (2004)
[16] Source: IMF World Economic Outlook 2004
[17] For details see Argentina Bondholders Committee (2003)
[18] See Porzeczanski (2004), p. 27
[19] The fiscal effort is measured by the so-called primary fiscal surplus, namely the excess of current revenues over current and investment outlays before consideration of interest payments.
According to Porzeczanski (2004, p. 27) the Argentine pledge for a fiscal effort of 3% falls short of the offers by countries in similar straits like Brazil, Ecuador and Turkey which were in the order of 4-6 %.

3% of GDP. This translates into an overall debt write off amounting to 75% of its outstanding debt on a present value basis. Moreover, Argentina announced in August 2004 the suspension of its IMF agreement, thereby giving up temporarily access to further lending and receiving freedom from IMF conditionality.[20] A political move that enables the Argentine government to emancipate itself from IMF oversight in the forthcoming debt-workout negotiations with private investors.

Based on its debt sustainability calculations the Argentine authorities have formally launched a debt swap offer to its private bondholders in early 2005 and lobbied financial markets in order to achieve an acceptable high participation rate of private investors. It is far from clear that the Argentine offer will attract a participation of 70% as envisioned by the authorities and it may prove as a risky gamble. Because of the rigorous approach by the Argentine government towards its private debtors, foreign bondholders may well shun the latest offer in high numbers.[21] This could open the floodgates to a succession of law suits, push the private sector to test their legal recourse to the limit and lead to a scenario which would leave all parties the worse off. While the high costs of litigation and the protection of state assets from embargoes have so far all worked to Argentina's advantage, the situation could change once the government manages to push through its restructuring with some of its creditors. A well-crafted lawsuit could stop payments to creditors who accept the government's offer as financial flows can not be embargoed. A committee of bondholders that is in disagreement with the offer by the sovereign could pool its holdings and sue the Argentine government in court for full recovery and complicate the restructuring process. [22]

From the experience in the Argentine restructuring process we can conclude that once insolvency occurs and debt becomes far too large to manage, there is little incentive for countries to work with the existing unenforceable system in finding a quick and consensual solution. The default of Argentina has been so far very costly, not only for its creditors but in particular for its citizens that have to bear long-term social and economic hardship. Moreover, even if the Argentine government will be successful in reaching a high participation in its recently offered debt swap the debt restructuring process may be endangered by possible litigation, due to collective action problems.

Therefore, this recent experience should reinvigorate interest in a more systematic and internationally recognized debt restructuring mechanism, as outlined in the next section.

[20] See Hornbeck (2004), p. 11
[21] Private bondholders have largely overcome their lack of cohesion by forming a Global Committee of Argentina Bondholders (GCAB) in 2004, which represents holders of $ 37 billion in debt. GCAB has been very vocal and is strongly opposed to the latest offer by Argentina. For further details see www.gcab.org
[22] Moreover, investors, including future funds, have been attracted to defaulted emerging markets debt in recent years, buying paper (bank loans, supplier credits or bonds) with the intention of suing for full recovery. Most of these investors have been successful in their litigation or out of-court settlements achieving on average 20 times of their investment. (see Singh, 2003 p.8ff)

4. The proposal for a new International Debt Framework (IDF)

The main objective of an orderly debt-restructuring mechanism at the incidence of sovereign default is to create an environment in which the debtor government can negotiate in good faith with all of its foreign creditors, such as multilateral and bilateral donors, commercial banks, bondholders and if necessary its domestic creditors. Furthermore, an entity that would provide continuous dialogue on crisis prevention between the international financial community and emerging markets' governments and policymakers could be another beneficial feature to the current system.

This section will introduce the proposal for a new operational instrument called International Debt Framework (IDF) and it would have two important functions:

1. *Provision of Transparency and Information on emerging market debt markets through regular dialogues between debtors and creditors (crisis prevention).*

2. *Facilitation of an orderly debt restructuring mechanism if requested by a sovereign defaulting debtor (crisis resolution).*

The proposal for an IDF recognizes that such a facility could only be successful if intergovernmental support and leadership by developed and developing countries could be ensured. Given the importance for such a mechanism for middle-income countries, we feel that the most appropriate forum for the establishment of the IDF would be the Group of 20. The G20 meetings of finance ministers from developed and developing countries have been a relatively successful forum to discuss issues such as how to deal with financial instability and better manage sudden capital inflows and outflows[23] and are by far more representative than institutions dominated by the G7.[24]

The underlying framework for the IDF is not statutory, in comparison to the SDRM approach of the IMF, and its principles would be established by best practices. In the case of a sovereign default it could allow for a multilateral convention by "all relevant stakeholders to restructure unsustainable debts in a timely and efficient manner"[25], as called for by the Monterrey Consensus of the UN Conference on Financing for Development.

4.1 General Principles / Code of Conduct

The non-statutory framework of the IDF proposal for the management of sovereign debt has to ensure predictability for international creditors. This could be achieved by the provision of a general set of principles that have to be formally endorsed by all G20 member states and

[23] See Sagasti and Bezanson (2004), p. 78
[24] Such institutions include the Financial Stability Forum, but also the Bretton Woods Institutions (BWIs). For a critique of the governance structures of the BWIs see Caliari/ Schroeder (2002) and Buira (2003).
[25] See Paragraph 60 of the Monterrey Consensus, adopted by the Heads of States and other Government Officials in Monterrey, Mexico 2002.

that will be supported by a majority of international creditors. In this regard a recent joint initiative for such a code of conduct by leading sovereign issuers (Brazil, Korea, Mexico and Turkey) of international bonds as well as leading private creditors could serve this purpose:

Box 1: Principles for Stable Capital Flows and Debt Restructuring in Emerging Markets

1. **Transparency and Timely Flow of Information**
   - **General disclosure practice**: Debtors should guarantee by means of disclosure of relevant information that creditors are able to conduct thorough assessments of debtors' economic and financial situation.
   - **Specific disclosure practice**: The debtor should disclose all information about the structure and amount of indebtedness to all creditors.
2. **Debtor-Creditor Dialogue and Cooperation to Avoid Restructuring**
   - **Regular dialogue**: Debtors and creditors should participate in a regular dialogue.
   - **Best practices for investor relations**: An investor relations office should be established to improve communication techniques.
   - **Policy action and feedback**: Debtor countries should enforce economic and financial policies to guarantee macroeconomic stability and promote sustainable economic growth.
   - **Consultations**: Debtors and creditors should assess alternative market-based instruments for restructuring debt.
   - **Creditor's support of debtor reform efforts**: Creditors should consider voluntary, temporary continuance of trade and inter-bank advances. In addition, the rollover of short-term maturities on public and private sector debt.
3. **Good Faith Actions**
   - **Voluntary, good faith process**: Debtors and creditors should ensure timely good faith negotiations.
   - **Sanctity of contracts**: Contracts should be maintained and only changed if both parties agreed upon.
   - **Vehicles for restructurings**: Creditor committee should be established flexibly and on a case by case basis.
   - **Creditor committee policies and practices**: In case a creditor committee is established it should use rules and practices, for example, coordination of various debt instruments or protection of non-public information etc.
   - **Debtor and creditor actions during restructuring**: Debtors should resume debt service payments, as far as possible. Debtors and creditors ensure that trade lines are fully serviced and preserved during a restructuring process.
4. **Fair treatment**
   - **Avoiding unfair discrimination among affected creditors**: Debtors should guarantee equal treatment of all creditors.
   - **Fairness of voting**: The result of a vote among creditors on a restructuring should not be affected by bonds, loans, and other financial instruments owned or controlled by the sovereign.

Source: For a more detailed description of this proposal see IIF (2004)

The principles, as listed in Box 1, have already gained support by leading industrial countries and developing country members of the G20, such as China, India, Indonesia, Russia and South Africa.[26] However, since a decision by the G20 for a Code of Conduct seems only be a

[26] Press Release, Institute of International Finance, November 22, 2004

matter of time, the effectiveness of these general principles for emerging markets finance will depend on a new international mechanism that promotes compliance by all relevant actors. This could be achieved by the creation of an International Debt Framework (IDF) as outlined in the following sub-sections.

4.2 Establishment of an IDF Secretariat and its Tasks / Functions

A first step for the establishment of the instrument of an IDF would be the creation of an IDF-Secretariat (see Appendix) which would include the first and second principle of the above mentioned code of conduct (Box 1) and take on the following functions:

- **Preparation and analysis of information**: The main function of this technical body would be the preparation and analysis of information on emerging countries debt markets[27] and of risk assessments to be presented in periodic status reports to the members of the G20.

- **Information exchange channel**: By facilitating regular dialogues between debtors, creditors and financial market experts the IDF secretariat could provide an important information exchange channel to lower market uncertainties.

- **Forum for G20 governments**: The IDF could also serve as a forum for G20 governments to address its economic policy decisions and debt problems, in particular if creditor's concerns are rising and economic difficulties are building up. The IDF Secretariat, which would serve as an instrument of crisis prevention, should stay in close contact with G20 finance ministries and other multilateral organizations such as the Bretton Woods Institutions, UNCTAD and the Financial Stability Forum and private sector entities that gather relevant information on financial markets.

- **Confidentiality of sensitive information**: One important feature of the IDF-Secretariat would be to ensure confidentiality of sensitive information regarding the G20 member's economic and financial situation that could otherwise lead to hasty conclusions and policy decisions by financial market investors.[28]

If the IDF-Secretariat could be successful in achieving acceptance and recognition in the international community and would serve as a successful convener for regular multi-stakeholder meetings on debt and development its contribution to a future orderly debt-restructuring mechanism would be of crucial importance.

Members of the IDF-Secretariat

The establishment of an IDF- Secretariat by the G20 would require a selection mechanism to nominate a small group of eminent experts on debt and economic development. To ensure

[27] This should also include price reporting by dealers and brokers on OTC securities.
[28] In the case of the incidence of sovereign default and negotiations for debt restructuring of a G20 country the disclosure of all relevant information of the debtor's financial and economic situation has to be ensured.

adequate representation of debtors and creditors, all stakeholders could nominate persons for the IDF-Secretariat. G20-countries who could be debtors or creditors need to be represented. Two or three persons could be chosen by the G20. Similarly, private creditor associations and International Financial Institutions could nominate persons to be a member of the IDF-Secretariat.

Creditors and debtors have to agree upon a concrete selection mechanism and the concrete number of persons. To ensure that this new body would not just be another agency in the international multilateral system the new body should not only be comprised of public officials.

Costs

Debtor and creditor countries as well as private creditors and International Financial Institutions would have to carry the costs because all parties benefit from the IDF-Secretariat.

4.3 The debt restructuring mechanism of an IDF

The debt restructuring process will be formally established by the creation of an IDF-Commission (IDFC) which will have the characteristics of an independent ad-hoc body (see Appendix). A Code of conduct will be recognized in the restructuring mechanism, in particular the third principle “Good Faith Actions” and the fourth principle “Fair treatment” of the above mentioned code of conduct (Box 1) should be valid.

Activation of a restructuring process

The debtor initiates the restructuring mechanism. Neither the creditors nor any international financial institution are entitled to activate a restructuring process under the IDFC. A restructuring process should be initiated in case a county’s debt is unsustainable. Exact criteria for unsustainable debt should be defined.

Members of the IDFC

It will be comprised of representatives from the debtor, private creditors, multilateral lenders and sovereign creditors. Members of the IDF-Secretariat should agree upon an appointment process for the restructuring mechanism and assist in the selection of mediators that will serve as external advisors in the negotiation process for an effective solution.

Tasks of the IDFC

The overreaching goal for the sovereign debt restructuring process by the IDFC will be to aim for a coherent and adequate solution that defines the amount of necessary financial support and an economic adjustment path that could ensure long-term debt sustainability. If a debt write-off would be necessary the IDFC would also define the level of debt relief.

The IDFC would be responsible for the valuation of claims. The value of external claims should be fixed on the date of activation. Furthermore, the IDFC would have the task to decide on any extension of the sovereign debtor's stay by consent of the majority of creditors.

The experience of the IDF-Secretariat in the preparation and analysis of information on emerging countries debt markets could be an important contribution to take into account an overall outlook on the international and domestic economy, the amount that official and private inflows might provide after the restructuring and the potential for economic growth. The IDF-Secretariat would assist the ad-hoc body by establishing early communication with creditors, facilitate the formation of creditor committees and classes.

Features of the IDFC

Types of debt be covered

Another important issue is the question of what claims would be restructured under the IDFC. The principle of equal treatment of all creditors would indicate for including of all types of external debts. For this reason all public – multilateral and bilateral – as well as private creditors should take part in the restructuring negotiations under the IDFC.

Bilateral public sector creditors should also be included in a restructuring process as a means of guaranteeing equal treatment for all creditors. Moreover, the bilateral public sector creditors constitute a very important group of creditors outside the private sector. In case the public bilateral creditors were not included, the only claims restructured under the IDFC would be those held by private and by public multilateral creditors. However, there is one disadvantage of an inclusion of all bilateral debt: bilateral creditors often provide trade credits, in particular for exports. These credits are important to the functioning of the economy and the country is endangered to be cut off from the world markets. Therefore, it may be reasonable in some cases to exclude trade credits from the restructuring process and to require that the sovereign debtor has to service such trade credits that are vital for the economy.

In general, multilateral creditors such as the IMF or the World Bank should not enjoy a privileged status. While it could be argued that the inclusion of multilateral institutions may endanger their financial viability, because of their limited amount of financial resources, it should not be ignored that their policy prescriptions and conditionalities may have contributed to the financial crises.[29] Given the special role that the IMF plays in providing new financing in times of crisis, its preferred creditor status should only be acknowledged if IMF conditionalities and the Fund's proposed economic policy framework will be subject to the restructuring negotiations under the framework of the IDFC.

[29] The default of Argentina is particularly revealing as the IMF was deeply involved with Argentina for many years prior to the 2001 crisis and Argentina's policies and performance were subject to intense IMF scrutiny and conditionality. For further details see Rambarran (2004).

The treatment of domestic debt in the restructuring process could follow different approaches. Even though the main objective is to reach sustainable levels of external debt, debtor countries' ability to repay their debt is affected by their domestic fiscal situation. Restructuring of domestic debt should therefore be coordinated with restructuring of external debt. It should be decided on a case by case basis if the claims of resident investors should be subject to the majority restructuring of all outstanding debt, or alternatively, domestic debt should be excluded from the scope of the IDF framework and the government should rely instead on the existing domestic legal frameworks to facilitate any restructuring of these claims.

Stay on enforcement

In the case that a financially distressed member country[30] of the G20 finds that it can no longer service its outstanding debt, it needs a stay on creditor enforcement in order to suspend temporarily its debt servicing to all of its creditors. Moreover, since a sovereign debtor that faces the risk of default is confronted with a severe coordination problem and has to find solutions for the provision of new financing, a stay would provide the sovereign debtor a necessary safeguard in times of crises.

One further advantage bound up with a stay is that it would make immediate debt restructuring possible, and thus creditors would have an incentive to participate in negotiations. In addition, a stay would contribute to equal treatment of all creditors because no creditor would receive payments during a stay. For this reason, a debtor cannot abuse a stay by making payments to preferred creditors.

One disadvantage of a stay, however is that it is important to keep the economies of debtor countries going. Payment of trade credits, for example, have to be maintained to keep up trade with foreign countries.[31]

Negative effects of stays, such as sudden capital flight or contagion effects on other countries, are overstated because these consequences are determined most likely by the general economic policy and performance rather than by stays.

The framework for the IDFC would provide a sovereign debtor with the right to seek a stay on creditor enforcement of 90 days by a qualified majority of G20 member states and initiate an orderly debt restructuring mechanism.[32] The involvement of the G20 members to weigh the evidence for the need of restructuring would encourage a credible behaviour by the sovereign debtor and could be justified by the risks involved for all G20 members as potential creditors (industrial countries) and future access for middle-income countries to private capital markets, that may be affected by contagion effects.

[30] In general, an established debt restructuring mechanism through the IDF Commission has not to be limited to members of the G20

[31] See Berensmann, K. (2003)

[32] The initial stay does not protect the sovereign debtor from litigation by its private creditors. It is widely accepted that there is a limited risk for a run to the courthouse, due to an unsatisfactory amount of assets that can be seized by foreign courts; see Bucheit / Gulati, (2000), p.1

After public announcement of the decision in favour of the sovereign debtor for a stay, the initial 90 day period would allow the private sector to organize themselves in creditors' committees for the forthcoming debt restructuring negotiations and the international financial institutions such as the IMF to find solutions for the provision of necessary financing.

Costs

Debtor countries would have to carry costs because they activate a restructuring process.

4.4 Civil Society Engagement

The long-term social and economic hardship that citizens of a financially distressed country have to bear even after a successful restructuring process do not justify that the parameters for a sustainable debt solution will be solely determined by a sovereign government and its creditors. It should be ensured that the need to maintain basic services and the goal of poverty reduction will be adequately addressed in the negotiations and social safeguards will become a mandatory feature in the overall package solution. In order to ensure accountability of the sovereign to its citizens public parliamentary hearings should be organized in which the government will report about the ongoing negotiations to its legislators and civil society organizations can make their case for a fair and sustainable solution.

4.5 Litigation and other legal issues

The proposal for the IDF does not offer a definite solution to prevent litigation. To inhibit litigation risks it would be necessary to establish a legally binding framework for an international insolvency procedure, but even such a procedure would not fully eliminate litigation risks. It must be noted, however, that litigation against a sovereign is difficult, takes a long time and its likelihood increases if the sovereign takes a long period of time to start a negotiation process with its creditors.

One recent example for successful litigation was the case of Elliott Associates against the Republic of Peru. In 1995, Peru offered a Brady restructuring which was accompanied by an IMF-program. Most private creditors accepted the restructuring, however, some creditors waited for better restructuring terms. Elliott Associates bought commercial loans that had been secured by the Peruvian Government, which were worth US $ 20.7 bn in the secondary market and rejected to participate in the restructuring procedure offered by the Peruvian government. The Peruvian authorities agreed to pay these creditors more than other creditors because they wanted to avoid costly and protracted legal action.[33] Exit consents are one instrument to prevent free rider behaviour by creditors and they have been successful to stop dissenting creditors from undermining the debt workout in the recent debt restructuring process in Ecuador.[34]

[33] See IMF (2001)
[34] See Nolan, J. (2001)

Exit consents

The objective of exit consents is to prevent free rider behaviours on the part of creditors in a restructuring of sovereign bonds involving conversion of an old bond issue into new collective action clauses. They allow for example that the majority ignores a minority of bondholders in a restructuring procedure. However, bonds issued under, for example, US law do not include collective action clauses. For this reason modifications of payment terms require the consent of all bondholders.

Exit consents / exit amendments allow a simple majority and the issuer to agree on an amendment of the terms of a bond contract without modifying payment terms. The contract on an old bond issue is amended in such a way as to make the old issue less attractive than a new one. Bondholders who do not participate in a restructuring process are penalized by the use of exit consents. Such amendments may, for instance, incorporate:

- Introduction of redemption free periods: the simple majority of bondholders and the sovereign agree upon redemption free periods.

- Reduction of bond liquidity: Old bonds are no longer listed on stock exchanges or quoted by dealers and are thus less liquid and more expensive to sell.

- Abandonment or dilution of financial contract clauses: It is possible to abandon financial clauses, e.g. cross default clauses. These clauses would enable bondholders to require immediate payment from a debtor who defaults on another bond issue.

- Cancellation of clauses that generally permit bondholders to participate in a debt restructuring process.

- Waiver of sovereign immunity: A sovereign issuer waives his immunity in a bond contract because a sovereign acts as a party to a contract, i.e. as debtor. On the basis of exit consents this waiver of immunity can be cancelled.

These exit consents or amendments serve to reduce attractiveness of original bond issues for creditors than the new bonds offered within a restructuring process. This sets an incentive for creditors to participate in the restructuring.[35]

[35] See Buchheit / Gulati (2000) and IMF (2001).

5. Conclusion

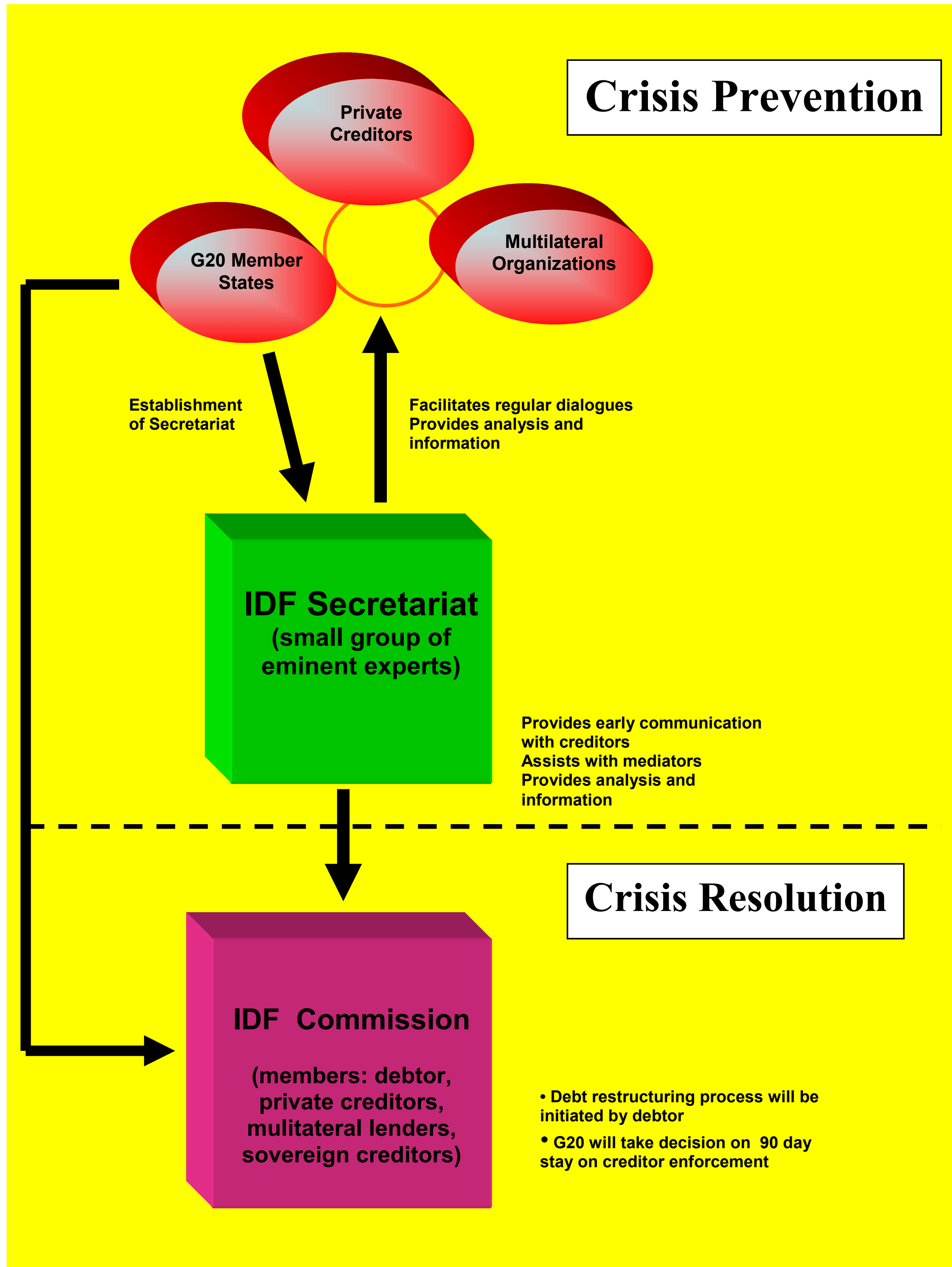
The absence of a robust framework for sovereign debt restructuring generates important cost and can create systemic instability in the international financial system. The problem is not only that current ad-hoc restructuring processes are disorderly and delayed, as shown in the case of Argentina, moreover, the lack of a comprehensive mechanism that deals with all forms of sovereign debt creates collective action problems that undermine the predictability of restructuring agreements. All this explains why it is important to find new solutions for crisis prevention and crisis resolution when a sovereign debtor faces an unsustainable debt burden.

This paper has laid out a possible approach for a new International Debt Framework (IDF) that tries to find middle ground between a legally binding insolvency procedure such as an SDRM and a voluntary code of conduct. First of all it recognizes the asymmetries in the governance structures of the international financial system by proposing the establishment of the IDF by the more representative forum of the Group of 20. As part of this approach, a first step would be the promotion of permanent debtor- credit dialogues and the provision of transparency and information on emerging market debt markets through the creation of a permanent IDF Secretariat. This institutional innovation could not only ensure the important element of crisis prevention, it could also built up trust and understanding between the different groups of creditors, which would be vital for potential debt restructuring negotiations, when they are required.

In comparison to the SDRM proposal of the IMF, the IDF approach allows for more flexibility in times of a sovereign's debt crisis as it is not statutory. The initiation of the debt restructuring mechanism by the sovereign through the Group of 20 would bring a temporary stay and the ad-hoc body of the IDF Commission into play. The IDF Commission would include all private and public creditors into the negotiations, make mediation service available and define the level of debt relief required for long-term debt sustainability.

Appendix

The structure of an International Debt Framework (IDF)



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