

REMARKS ON THE PROPOSAL TO CREATE A SOVEREIGN BANKRUPTCY COURT

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1. The debate around the definition of bankruptcy procedures for sovereigns has a long history. In the recent past, specific proposals were made both by international organizations, like UNCTAD, and by academicians like Jeffrey Sachs. These proposals, however, were entirely ignored by the international community until the general idea was advanced, in a passing remark, by US Treasury Secretary Paul O'Neill in a testimony given to the US Senate on the financial consequences of the terrorist attacks of September 11, 2001. The suggestion was quickly taken up by the IMF's Anne Krueger. Since then the IMF has been proposing the creation of bankruptcy procedures for sovereign nations facing unsustainable external liabilities. This proposal, which seemed at first to enjoy the support of the US government, was rejected by the Under Secretary of the Treasury, John Taylor, in the Spring meeting of the Fund. Taylor advanced his own preferred alternative, considered to be more market-friendly, of requiring bond contracts to include collective action clauses that allow the terms of bonded debt to be renegotiated when the debtor is unable to service its debts. The Fund's management, however, still insists on its proposal and the matter will be decided in future meetings. This note is not intended to properly examine the proposals being advanced in their entirety. All that it is intended is to highlight some elements that are important to keep in mind when examining the position to assume with respect to these ideas from the point of view of emerging economies.

2. It may be important to remember, at the outset, why this discussion has finally arrived at such institutions as the Fund and aroused the interest of authorities such as O'Neill, Gordon Brown or Laurent Fabius, after years of complete oblivion. One may see it in the context of the search for ways to promote private sector involvement (PSI) in crisis solution and prevention. Balance of payments crises that originate in imbalances of the capital account present a different challenge to institutions such as the IMF (and its sponsors, such as the US or the European countries) than that represented by past crises. In the past, formal and informal capital controls were pervasive. Under these conditions, BP crises could only originate in the current transactions account. Imbalances in this account are relatively limited in size and take time to develop. This allows crisis solutions to be developed involving limited amounts of resources. Beginning with the Mexican crisis of 1994/5, capital account crises involve large amounts of money and develop very quickly. This is so, because once capital accounts are liberalized, capital flight becomes accessible literally to everybody that holds any financial asset (including local currency) in the afflicted country. Thus, when the crisis took place in Mexico, Thailand, Brazil, etc, the possibility of exchanging local currency for dollars was open to a large number of people. Under these conditions, if a country tries to defend its currency, it will lose reserves in a matter of days, if not of hours. This means that restoring some stability requires loans from institutions like the IMF, that are much larger than the resources it actually holds. Rescue packages tend to

* From IBASE (Rio de Janeiro, www.ibase.br) and the Institute of Economics, Federal University of Rio de Janeiro. These remarks were presented at the seminar on alternatives to neoliberal policies, Washington (DC), May 23 and 24, 2002. The opinions contained in this note are the author's and do not necessarily represent Ibase's position on the matter.

exhaust the Fund's available resources and still to demand additional support from other institutions, like the World Bank or regional development banks, and countries.

3. Rescue packages served mostly to socialize debts. Private lenders are paid back with the resources that are made available, and the afflicted country becomes a debtor to the Fund for the same value. That is why there is so much criticism of the intervention strategy, that ends up bailing out private lenders. The burden of debt falls then entirely on the debtor country, that now faces obligations to senior lenders (since failing to pay debts to the Bretton Woods institutions are seen as a much more serious fault than defaulting on debts with private lenders). The rescuers are also left with the risk that the debtor ends up being incapable of paying back the loans anyway.

4. PSI is sought by the international financial institutions, under the prodding of the US and other developed countries, to reduce the risks run by the IFI and, indirectly, by the sponsor countries that face the possible need to increase their contributions to those institutions. The goal is to involve private lenders by having them to accept the restructuring of debts when the debtor is proven to be unable to honor its obligations so as to avoid capital flight and the need to adopt rescue packages, or at least reducing their size.

5. The central question in the debate referred to in paragraph 1 is how to involve private lenders in the process of crisis avoidance or crisis solution. Two possibilities have been put on the table in the current discussion between members of the Fund. The first is inspired by domestic bankruptcy procedures, particularly chapter 11 (or 9, according to some) of the US Bankruptcy Code. In this approach, similar institutions had to be created that would allow the debtor country to take the initiative to seek protection against creditors under specified conditions. If this protection was granted (and here is the first problem: who should grant it), not only the debtor could temporarily halt payments on its external obligations, but it could even seek new loans to keep operating, these new loans being senior to outstanding obligations. The debt standstill would last the minimum time required for the parties to reach agreement about the new debt profile. In exchange, the debtor country would accept limitations on its domestic and foreign policies such as not to create additional risks to creditors. In other words, conditionalities would still be imposed for the period of the standstill.

6. The second alternative is to include in bond contracts a clause allowing a qualified majority of creditors to renegotiate binding agreements to restructure unsustainable debts. In this case, the debtor country loses the initiative, and the terms of renegotiation will depend on the understanding between the parties involved. The details as well as the general virtues and vices involved in each proposed are well known or can be easily learned from the examination of Krueger's proposals (available in www.imf.org) and from Taylor's speeches, available in the US Treasury site. The rest of this note is dedicated just to highlight some matters of interest for emerging economies that may have to rely on such arrangements in the future.

7. The first question to be raised relates to what is being accomplished in case one or the other alternative is adopted. It is important to distinguish two different types of BP crises that have afflicted developing economies in the recent past. Since the 1994 Mexican crisis,

and including the Asian and Brazilian crises that took place afterwards, BP problems have been mostly caused by lack of liquidity rather than by insolvency. *Illiquidity* is the situation in which a debtor is unable to honor its debts when they come due, due to cash flow mismatches. This is to be distinguished from *insolvency*, when instead of a temporary difficulty to pay, the debtor is permanently unable to pay (technically, it means that the present value of its liabilities exceeds the present value of its assets, so it is useless to prolong its life because it will still be unable to pay back its debts in the future). Illiquidity means that if payments are postponed (the debt is rolled over) the debtor will be able to honor its debts later. In principle, no reduction of the value of the debt is necessary. However, an illiquidity crisis can become an insolvency crisis if the debtor is forced to fire-sale assets to serve its debt.

8. The most efficient solution to an illiquidity crisis is the creation of a lender of last resort, some institutions that could lend money to the debtor allowing it to honor its debts when they come due, avoiding the need to liquidate assets in a fire sale. For some, the Fund should assume this role judging that the capital account crises of the 1990s could have been avoided if the Fund had really acted in this capacity. There are important obstacles that prevent the Fund to become an authentic lender of last resort. Under these conditions, a standstill could be a second best. It would give time to the debtor to prepare for servicing the debt when its external revenues allowed it, preserving orderly conditions in the international financial markets.

9. Neither Krueger's nor Taylor's proposals seem to be intended to deal with these crisis, focused as they are on unsustainable debts. Nevertheless, an orderly process to achieve a payments standstill is of the utmost importance for emerging economies. The alternatives, during a financial crisis, are either to appeal to the Fund for rescue packages or to declare a unilateral moratorium, both of which profoundly disturbs financial markets. The proposals have to be amended to explicitly cover dealing with liquidity crises.

10. Insolvency crises did afflict some emerging economies in the 1980s, and is most certainly the current case of Argentina. But at this moment it is rather the exception than the rule if one thinks of emerging economies. On the other hand, unsustainable debt is the problem of HIPC's. For these countries, neither Krueger's nor Taylor's ideas are of much use. In these case, creditors are overwhelmingly official, either governments or IFIs. There is definitely much to be improved in the HIPC process, but creating bankruptcy procedures would help very little and defining collective action clauses even less.

11. From the point of view of the emerging countries, and assuming that the proposals are extended to consider illiquidity crises besides insolvency crises, the bankruptcy court is a much more promising instrument than the collective action clause to deal with BP crises. If one keeps in mind the size and speed of the crisis originated in capital account movements, the bankruptcy procedures give debtor countries the advantage of taking the initiative and of seeking a centralized decision on a standstill that is valid for all foreign payments. Collective action clauses only open the possibility of renegotiation, but creditors can stall any decision. In fact, if one considers that debtors get weaker by the minute when a crisis begins, it is natural to think that creditors would stall to obtain better bargaining positions. In fact, the Fund already does this, as the recent case of Argentina shows. The more the

creditor waits the more likely it is that debtors will accept anything out of desperation. To see the collective action clause as much more market-friendly is definitely a very apt characterization.

12. If some variation of the bankruptcy court is better for developing countries than the collective action clauses or the current status quo, a number of problems still remain to be clarified. First and foremost, there is the question of conditionalities. A standstill is granted in exchange to the acceptance of policies designed to guarantee the rights of creditors. This is similar language to the one in the Fund's Articles of Agreement that gives the right to impose conditionalities. Excessive conditionalities, in number and in coverage, were perhaps the most important problems created for developing economies as a consequence of BP crises. After the Fund self-attributed the mission to guide the development of developing countries, it has been meddling in a completely illegitimate way with domestic policies. Even conservative economists, like Allan Meltzer acknowledged that this meddling is unacceptable. So the question of conditionalities in this new procedure has to be clarified.

13. Secondly, if such procedures are in fact designed, one should expect an increase in loan costs to emerging economies. It is reasonable to expect that these costs would increase because for creditors the current situation (or that which prevailed in the 1990s) is definitely more comfortable. Once private lenders are convinced that rescue packages are history, financial markets will probably recognize the value of dealing orderly with payments problems as opposed to a disorderly process as we see, for instance, currently in Argentina.

14. Finally, there is the central question of which institution should preside such a process. It is generally accepted that it cannot be the Fund, either because it is a creditor itself or because it represents in a disproportionate way the countries where loans are originated, even if private, in contrast to debtor countries. An impartial arbitrator would be necessary, that could be a permanent institution, specialized in dealing with sovereign debt, or an ad hoc entity created each time an intervention is needed. There are pros and cons each of the last alternatives, but it is clear that the Fund could *not* assume this role.