# A SIMPLE MEANS TO DEFUSE SOVEREIGN DEFAULT

By
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All over the globe, emerging economies are facing the consequences of years of overspending by countries and overlending by the capital markets, from the Mexican bailout in 1995 to the Argentine collapse in 2001. There will be default, the restructuring of debt, the decimation of domestic savings and painful retrenchments to bring fiscal budgets in line with reality. Unlimited IMF resources for rescue, funded by Group of Seven taxpayers, are no longer to be had for the asking.

There is now a grand total of $1.5 trillion in international emerging market sovereign debt. Latin America accounts for a significant 28% but its share in the financial markets is overwhelming--40% of the $640 billion developing government debt owed to the private sector and more than half of the $410 billion bonds held in investor portfolios. Levels are clearly unsustainable: economic growth is only 1-2% per annum; dependence on agricultural and commodity exports, both of these low margin and volatile, continues; and old-time populist political agendas are on the rise.

Economic concerns do not always respect political boundaries. Our neighbors may some day be our future partners in the Free Trade Area of the Americas (FTAA) which plans to integrate the free flow of goods and capital throughout the Western hemisphere.

There is hardly a country in Latin America where rumors of financial failure do not circulate. In December 2001, Argentina halted payment on $100 billion of foreign obligations (a massive 22% of the entire emerging bond total). Almost a year and a half has passed without attempt at resolution. In the summer of 2002, Brazil required a $30 billion IMF loan to bolster its credibility with lenders and maintain access to funds.

Default has become a matter of semantics as finance ministers and the multilaterals hide behind technicalities. Rating agencies and the markets are not deceived. Even two emergency packages in swift succession did not mend Uruguay's balance sheet. A debt restructuring, described as "voluntary", is underway that will soon force investors to accept an effective reduction in the value of their claims by extending maturities 5 years. Venezuela is demanding a restructuring of its debt while professing to honor its payment promises. Ecuador, which struggled through a comprehensive debt exchange after defaulting in 2000, is about to return for another round of attrition for creditors. Paraguay has announced that it cannot pay what it owes. Colombia, Peru and Bolivia are question marks. Many solutions will be stopgaps that provide only temporary respite and prepare the bond contracts so that the inevitable restructuring will be easier to execute.

New means must be found and swiftly to defuse this unstable environment without triggering international crises and without diverting global investment flows from developing nations.

**Root Cause: No Risk; High Return**

In 1995 in Mexico, then US Treasury Under Secretary Lawrence Summers stretched forth his hand and gave life to a financial anomaly: an asset with a high rate of return *and* with an unwritten AAA guaranty via IMF bailouts. The natural laws of the risk/return tradeoff were contravened; the demand was explosive. Annual bond issuance by Latin American governments that totaled only $9 billion before the rescue instantly quadrupled to $37 billion.

Bailouts grew with borrowing. Official loans to save faltering economies and their creditors mounted to $250 billion by 2001 and were still climbing. Group of Seven taxpayers were staring at a long list of payouts down the road. When the IMF kept its hands in its pockets and Argentina was allowed to default, the forgotten process of debt restructuring recaptured the international agenda.

**Collective Action is the Cure**

Everyone agrees that an orderly framework is needed to contain what English jurists a century ago labeled the "tyranny of the minority" from blocking the swift settlement of claims. A pattern is provided by UK collective action clauses where a 75% supermajority of creditors can conclude an agreement with debtors that binds all lenders; US bonds traditionally have required 100% accord. The clauses must aggregate all bonds and all loans, both old and new. Otherwise vulture investors who control a single small issue can hold the entire restructuring hostage. This requires that every outstanding contract be retrieved and rewritten at an expense that emerging governments are loath to assume.

**The Way is Clear, the Argument is about Means**

For more than a year, the IMF pursued a vision of a global bankruptcy court to control borrowers and lenders by legislative fiat when sovereign debtors fail. This equivalent of a corporate forum would have overruled the laws of all nations and superceded the contracts of all existing debt. It was a losing battle to convert a hostile audience from both developing government debtors and capital market creditors. Even diluted powers and an innocuous new name as the Sovereign Debt Restructuring Mechanism (SDRM) did not allay fears that any official format, no matter how limited its initial reach, would constitute an opening wedge that could later expand its powers. When finance ministers and central bankers from 184 nations met at the Fund's 2003 Spring Meeting, the plan was gracefully sidelined.

The US Treasury continues to call for brave pioneers to adopt collective action clauses in new bonds and to recall old instruments for exchange. Highly credit-worthy Mexico's two recent issues, $3.5 billion in all, were the first US bonds to streamline the restructuring of debt. But the purchasers were investment grade asset managers; they did not attract the crucial audience of emerging market investors. Voluntary changeover across the spectrum of developing economies will be long in coming.

Crisis itself is a traditional means to enact reform but this is expensive. Collective action clauses can be exacted as the price of emergency aid but desperation timing encourages markets to extract the maximum for agreement; Uruguay is the present experiment. But there is a serious price to the system if we wait to complete a long cycle of defaults, rescues and exchanges.

**Incentives: A Simpler Solution**

Why seek in distant, costly and convoluted solutions what is already close at hand? Why not align self-interest with the common good by making it profitable to accept constructive change and expensive to refuse? The means to correct the past and accelerate the future are right in the charters, balance sheets and tested procedures of the Bretton Woods institutions.

First, the IMF should confer with borrowers and lenders to set a global standard for bond contracts. Next, to spare developing nation budgets, the Fund should assume the transaction fees for the conversion of the entire $500 billion long-term emerging sovereign debt already out in the international market into identical instruments with protective clauses incorporated. A series of auctions will empower the market to set a price that reflects the collective view of the value of the new safety measures. Exchange charges of $1 billion, or 0.20%, for cleaning up the whole system would be a bargain compared to even one bailout.

Finally, make governments face a simple choice: incorporate IMF approved collective action provisions in new debt *and* convert outstanding issues to the new format or pay a 3-5% surcharge on both IMF loans for emergencies and on World Bank loans for development--an immediate penalty that far exceeds any imagined rise in borrowing costs. Revenue from the surcharges will pay the conversion costs. Those who continue to be a source of the problem will become the source of conversion funds.[1]

[1] Interest surcharges have been used by both the IMF in its Supplemental Reserve Facilities and the World Bank for its crisis lending programs.

Should acceptance be total and immediate, any cash shortfall can be divided equally between the developing and industrialized worlds. There is a precedent for the IMF to find special funding through adjustments to the interest rates it charges on loans and the interest rate it pays for its resources from rich members. Who will notice a 1/8% difference for the next five years?[2]

There will be no profit to vultures in disrupting the conversion. As the exchange takes place, as few as 51% of bondholders can approve amendments to the old bonds they have rendered that will effectively destroy the value of any stockpile hoarded by holdouts. Without formal default, vultures have no ability to sue and extract a ransom from countries anxious to return to the capital markets.[3]

**A Role for the IMF**

Hope for a return to the entitlements of subsidized funding and riskless lending still lingers. However widely adopted the new contracts, only an unwavering IMF stance against bailouts will compel engagement on all sides of the restructuring table.

But the division is no longer between creditor and borrower or between capital markets and the official sector but between serious investors and speculators who thrive on panic. Lenders with long term interests and developing countries seeking growth would do well to rethink past partnerships and forge new alliances.

But what of the rights of the silent third party to every sovereign debt transaction? It is the taxpayers of the Group of Seven rich nations who have historically paid the price of the unsustainable debt of others both in the fallout from financial panics and in the tithe for bailouts. The official sector remains the only voice for those who underwrite the cost of stability in the international financial system.

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[2] The IMF utilized adjustments to its lending and remuneration interest rates to accumulate funds for the Special Contingent Accounts in the 1990's.

[3] Exit consent amendments would induce participation. Upon acceptance of the exchange, holders of old bonds would approve amendments to the non-payment terms of the bonds that reduce their value significantly (acceleration provisions, listing, etc…). Once the requisite majority of a bond issue has accepted the amendments (51% or 67% depending upon the issue), they would be binding on any remaining holders.
In contrast to exchanges after default has occurred, there is every incentive to convert. There is nothing to gain from keeping amended old bonds, for investors would simply be left with a claim with reduced protection and liquidity. Vultures would not be attracted to the old bonds because there is no profit in disrupting the exchange. Since no event of default would have occurred, there would be no ability to sue and extract preferential treatment. Stockpiling old bonds today on the chance that, at some distant uncertain date, a payment default will occur and a nuisance value will materialize is not a profitable strategy.