DEBT RENEGOTIATION FRAMEWORK

October 2005

Dusan Zivkovic

UNCTAD

Paper prepared for the expert group meeting on Debt Sustainability and Development Strategies.

1. Introduction

Cross-border debt financing is considered an important vehicle for mobilizing resources for public and private investment in developing countries. In large part, the necessity to resort to international financing comes from the undeveloped state of domestic capital markets, which lack both the size and depth to permit governments to raise funds in local currency. Inherently, this state of affairs puts borrowers at a greater risk as compared to those that can borrow in local capital markets, as they are faced by both exogenously determined interest rates and currency risk. Taking into consideration that in the medium term there is limited scope that developing countries will be able to forfeit the option of borrowing from abroad, the international financial community and developing country governments have been working closely to ensure that the debt situation resulting from such financing does not become unsustainable. However, the last three decades have shown that external shocks, natural disasters, and balance of payments difficulties can result in a country's inability to continue servicing its external debt.

Over the years, a number of mechanisms have been developed to deal with debtors' inability to meet their financial commitments. The current set of institutions and informal organizations that a debtor country needs to approach is quite numerous, making a debt restructuring operation multifaceted, costly, and time consuming. For example, to address the rescheduling of official bilateral debt, debtor countries need to approach the Paris Club, and reach an agreement with all the represented creditors, while an economic program supported by the IMF needs to be in place prior to the negotiations taking place. However, as all the official bilateral creditors are not members of the Paris Club, a number of further bilateral negotiations with these countries need to take place in order to reach a comprehensive rescheduling of official bilateral debt. On the other hand, the inability to service commercial debt leads debtors to enter into a rescheduling discussion with the London Club, which has a different set of procedures from the Paris Club, and where negotiations can be extremely protracted. As the importance of private debt has increased substantially since the 1990's, in particular for middle-income countries, the issue of bond restructuring has come to the forefront of discussions on debt rescheduling. Private external debt finance, especially in the form of bond issuance, carries some complex legal features making a debt workout difficult to manage. At present, the mechanism for resolving such a situation remains un-institutionalized, and is mostly governed by precedents, guidance on best practices, and ad-hoc solutions.

In all cases, a debtor country will need to prepare an all-encompassing restructuring strategy and to co-ordinate its negotiations with the different creditor groups, as well as with the international financial organizations, in particular the IMF, while the sequencing of talks with various creditors will mostly be governed by the structure of a country's debt. Besides the organizational and technical difficulties associated with launching a rescheduling process, the more fundamental question as to the cause of debt servicing problems will be the key determinant for the outcome of the debt talks. In particular, whether debt-servicing difficulties are a result of liquidity or structural problems in a debtor country, different treatments of the debt will be required in order for a country to regain external financial viability. Yet, it is precisely in this area that most of the diagnostic problems arise. Although the analytical tools to distinguish between the two types of problems have substantially evolved over the last fifteen years, a number of problems remain[1] which make it often difficult to claim with any degree of certainty that a liquidity problem will not evolve into a structural one. This implies that a debtor country might be faced will multiple rescheduling exercises, which in themselves create uncertainty and have negative repercussions for growth.

Furthermore, the broader question that arises in the context of the current international financial architecture is whether the existing set of practices for dealing with a country's debt problem is rational. While it is clear that different types of debt require discussions with various classes of lenders, the system of atomized negotiations with each lender group separately might be inefficient both from an economic point of view and from the aspect of a quick resolution to a debt crisis when it occurs. Yet, both debtors and creditors stand to benefit from a quick resolution to a debt default.

[1] One of the variables that is not easily quantifiable is the degree of political and social cohesion in a country, which is a determining factor for the decision to generate primary surpluses necessary to stabilize the debt dynamics over a projected period. Another key variable that involves some degree of subjective judgment is the quality of institutions in any given country. Different assessments of institutional capacity and the quality of policies will greatly influence the sustainable level of debt, as studies have shown that countries with weaker institutions have lower thresholds at which the debt burden risks becoming unsustainable.

2. Historical background

Although the current debate on improving the international financial architecture gained momentum in the mid 1990's, the question of orderly debt workouts and an appropriate international mechanism to support debt rescheduling is by no means new. In 1971, the Group of 77 adopted the "Declaration and principles of the Action Programme of Lima"[2], calling for orderly debt workouts which explicitly take into account the development implications of a heavy debt servicing burden, and stressing the need for the establishment of a new international mechanism for dealing with developing country debt problems. The underlying idea of the Declaration was that an independent forum should be created whose function would be to supervise the negotiations on debt reorganization. The authors of the Declaration argued that the creation of such a forum would provide for an institutional arrangement that would have independence, permanence, authority and technical competence. Furthermore, the Group of 77 called for a method for dealing with debt in a comprehensive manner, which would do away with the necessity for a debtor country to go to a succession of meetings, each dealing with individual aspects of its debt problem. The most concise and well-articulated document relating to this line of thinking can be found in the G-77 paper for the UNCTAD V conference, drafted at the G-77 ministerial Meeting in Tanzania in 1979, calling for the establishment of an International Debt Commission. It called for "*The establishment of an international debt commission, comprising eminent public figures with recognized knowledge and experience of debt problems and economic development. Any interested developing country which believes it has, or may have a debt problem could address itself to the commission. The commission will: i) examine the debt and development problems of the requesting country; ii) in the light of such examination and in accordance with the modalities of the detailed features, make recommendations on the measures required to deal with the debt problems in the broader context of development including measures of debt reorganization and additional bilateral and multilateral finance; iii) convened a meeting of all parties concerned with a view to implementing the recommendations under ii) above* ."

After eight years of effort by developing countries to change the international financial practices, such a mechanism was not created. However, the intense debate on debt reorganization mechanisms, and debt problems more broadly, which took place in the context of the 1970's North-South dialogue, led to a series of negotiations and gave rise to the progressive shift of views on the causes of debt difficulties confronting a number of countries. During a series of discussion from 1975 to 1977 under the auspices of the Conference on International Economic Cooperation, the OECD countries for the first time explicitly acknowledged that some of the debt problems are linked to "longer term situations relating to structural, financial and transfer of resources problems"[3]. The acknowledgment that a number of debt problems could be linked to structural issues can be seen as giving the first impetus to the current debate on debt sustainability. During the 1980's and 1990's, UNCTAD continued highlighting that the international financial system lacks a fair and efficient

[2] …."The criteria and procedures of rescheduling … should be reviewed and revised so as to ensure that the rescheduling of debts does not interfere with the orderly process of development planning in debtor countries and should be systematically designed to prevent both disruption of long-term development plans and need for repeated rescheduling. A special body should be created within the machinery of UNCTAD to find practical solutions to the debt servicing problems of developing countries." UNCTAD, TD/143, 12 November 1971

[3] See OECD position paper for the Conference on International Economic Cooperation, 1976.

mechanism for resolving sovereign debt problems[4]. The UNCTAD position is reflected in the 1986 Trade and Development Report, that

"The lack of a well articulated, impartial framework for resolving international debt problems creates considerable danger, which has in part already materialized, that international debtors will suffer the worst of both possible worlds: they may experience the financial and economic stigma of being judged *de facto* bankrupt, with all the consequences that this entails as regards creditworthiness and future access to financing. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States bankruptcy Code".

The initiative for creating a comprehensive debt restructuring apparatus had been around for well over a couple of decades by the time that in 2001[5] Anne Krueger floated the idea of the creation of a Sovereign Debt Restructuring Mechanism. Although the SDRM contains a number of new modalities, it reflects the same logic as the proposal for the creation of an International Debt Commission, i.e. that an institutionalized international system for dealing with debt problems of developing countries would be supportive to an efficient resolution of debt crisis.

It is also in the 1970's that the idea of debt relief as an aid mechanism for the poorer countries came to the forefront of international thinking. During the mid 1970's, OECD donor countries adopted a policy of extending new aid to the thirty least developed countries solely in the form of grants in order to avoid future debt servicing difficulties. The parallels with the current policy of new financing for post-HIPC countries are striking. Thirty years later, the World Bank policy for countries that have graduated from the HIPC initiative is anchored on the principle that the new forms of lending should take mostly the form of grants, or loans with a high grant element.

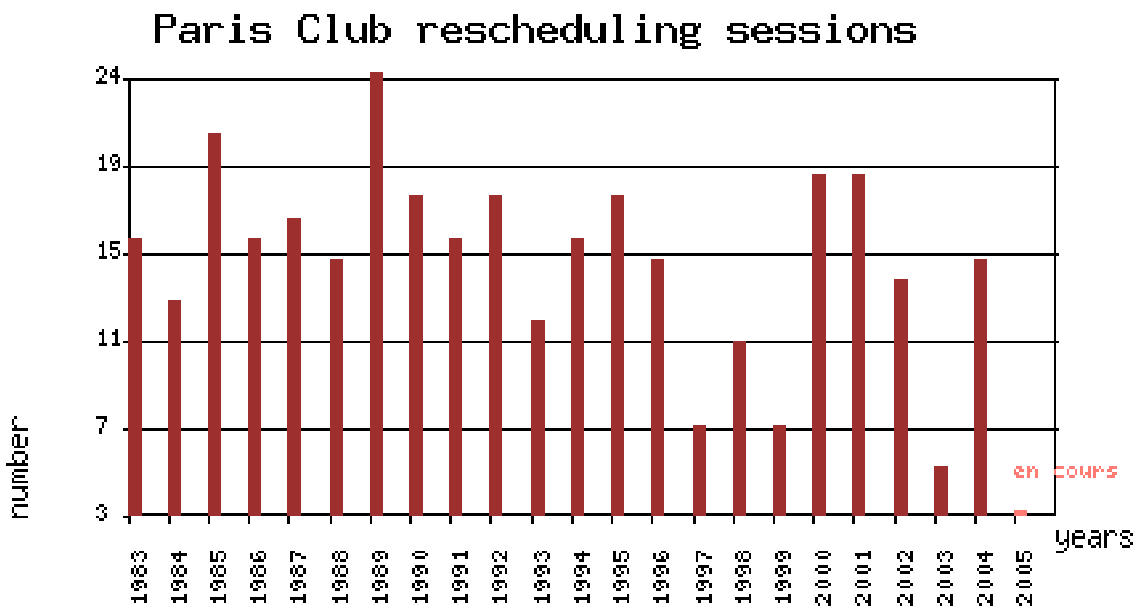
Taking into account the number of discussions during the 1970's on debt problems and the inefficiency of rescheduling mechanisms, it is somewhat surprising to what extent the international financial system was unprepared for the debt crisis of the 1980's.

[4] See: "Trade and Development Report" 1986 and 1998.
[5] See address by Anne Krueger given at the American Enterprise Institute, Washington DC, November 26, 2001

3. Official bilateral debt : Paris Club

A) Background

Although the first meeting of the Paris Club can be traced back to 1956, when Argentina met with its official creditors in Paris, the bulk of rescheduling took place after 1983 amidst the debt crisis that developed in the early 1980s.



Source: Paris Club Secretariat

In the first twenty years of its existence, the Paris Club operated with little or no transparency, which became one of the topics of the North-South dialogue during the 1970's. In order to respond to this criticism, the Paris Club secretariat started a conscious effort of codifying its procedures, as well as making them available to the public at large. The culmination of this endeavour was the creation of the Paris Club website[6] in 2001, which carries all the relevant information on Paris Club activities, except the text of the Agreed Minutes signed between the creditors and a debtor government at the end of the negotiation.

The first quarter century of the functioning of the Paris Club gave rise to five principles that guide creditor decisions during the negotiations.

- Decisions on debt relief are taken on a case-by-case basis.
- Decisions by creditors on the terms of debt relief are taken by consensus.
- The requirement that a debtor country has signed an IMF supported programme, which demonstrates the need for debt relief.

[6] www.clubdeparis.org

- All participating creditors agree to implement, on a bilateral basis, the terms agreed at the Paris Club meeting.
- Comparability of treatment between creditors, requiring the debtor country to seek a rescheduling on comparable terms to those negotiated within the Paris Club with its non-Paris Club creditors.

In practice, Paris Club creditors do not assign the same weight to all of the above principles. Whereas the first four principles have been strictly adhered to, the comparability of treatment has been much less firmly observed. Over the years, both debtor countries and Paris Club creditors repeatedly raised the issue of the difficulty in achieving comparability of treatment both with non-Paris Club official creditors and in some instances with London Club creditors. It is now widely acknowledged that the current international financial system does not have an adequate mechanism for ensuring the participation of non-Paris Club creditors in a debt relief effort for a sovereign debtor. This has posed a major challenge in achieving an efficient debt restructuring mechanism, as a partial debt relief by one group of creditors without the participation of others can often be insufficient for restoring debt sustainability of a country.

B) Evolution of terms

As the debt rescheduling meetings became more frequent during the 1980s and 1990s, the analysis of the debt problem started evolving from the position that the debt servicing problems faced by developing countries are strictly a liquidity problem, towards a view that a number of countries are suffering from structural difficulties that make their debt burden unsustainable. The acceptance of the idea that repeated flow rescheduling is not the solution to the debt problems of a number of developing countries is reflected in the evolution of the terms Paris Club creditors offered to debtor countries over the last couple of decades. The turning point came in 1988 with Toronto Terms, which for the first time addressed the issue of debt stock reduction for poor countries. Eligible countries obtained a thirty three percent reduction of their debt stock, but this soon proved to be insufficient, and in 1991 London Terms, which granted eligible countries a fifty percent debt stock reduction, replaced Toronto terms. A further enhancement to the reduction efforts came in 1994, with the adoption of Naples terms that allowed for a sixty seven percent reduction of the debt stock.

However, as the official creditors were decreasing the stock of debt of the poorest countries, no such mechanism existed for the multilateral debt, whose share in the external debt position of the poorest developing countries continued increasing. It was soon realized that a more comprehensive scheme was needed in order to successfully tackle the debt problem of the poorest countries. The proposal for the Highly Indebted Poor Countries Initiative was launched in 1996 at the G-7 summit in Lyon. The original proposal envisaged an eighty percent reduction in net present value terms of the debt stock of eligible countries, which was increased to ninety percent under the Cologne Terms. The main feature of the HIPC Initiative is that for the first time the multilateral debt stock was treated as part of the debt relief effort. The architects of the Initiative envisaged that a simultaneous treatment of both official and multilateral debt, characterized by a large cancellation of the debt stock, would provide for an exit from repetitive debt rescheduling operations.

Almost ten years later, it is clear that the HIPC Initiative did not meet all its proclaimed goals. The process for countries to benefit from the Initiative was lengthy, and characterized by a complexity that burdened countries' already weak institutions. Furthermore, the Initiative has continually faced financing problems, making a quick resolution to debt problems of HIPCs impracticable. Although there is progress with regard to debt service to export, and debt service to government revenue indicators for HIPCs as a group, a number of countries that have reached the completion point and graduated from the Initiative remain with an unsustainable debt level[7]. In a further effort to resolve the debt problem of the poorest countries, in July 2005 the G-8 recommended a complete cancellation of outstanding obligation to the IMF, the World Bank and the African Development bank of the HIPCs that have graduated from the Initiative.

One of the main limitations which remains in place with regard to not only solving the current debt problem of HIPCs, but also limiting the risk that some of these countries do not plunge into a new debt crisis is the limited participation of non-Paris Club creditors in the write-offs, and the litigation by some private creditors who refuse to accept any write-off on their claims. Even though private creditors account for approximately two percent of the total debt relief, litigation produces administrative and financial costs for HIPCs, and underlines the lack of a mechanism for dealing with developing countries' debt problems in a comprehensive manner. Moreover, some lenders are not following the World Bank principle of extending only highly concessional loans or grants to post HIPC countries, thus potentially paving the way for new debt servicing difficulties a few years from now.

Although the 1990's were marked by a major effort to deal with the sustainability problems of the poorest countries, the question of the sustainability of middle-income countries was not extensively examined. It is only after the Argentine default in 2001 that both private and official creditors started focussing their attention on improving the existing mechanisms for dealing with debt problems of middle-income countries. In this context, the G8 tabled a new approach to dealing with the debt problems of middle-income countries during their 2003 summit in Evian.

[7] The case of Bolivia is often cited as an example of the limitations of the HIPC Initiative in ensuring debt sustainability.

Date	Standard terms of treatment	Description	Stock Reduction
1956	Classic terms	Standard treatment: Credits (whether ODA or non-ODA) are rescheduled at the appropriate market rate with a repayment profile negotiated on a case-by-case basis.	0%
1988	Toronto terms (later replaced by Naples terms)	This new treatment implemented for the first time a reduction of part of the debt of poor countries. Concerning ODA credits, they were rescheduled with a 25-year repayment period including 14-year grace. Non-ODA credits were cancelled to a 33.33% level through one of the three following options: -"Debt reduction option" ("DR"): 33.33% of the claims treated were cancelled, the outstanding part being rescheduled at the appropriate market rate with a 14-year repayment period including 8-year grace. -"Debt service reduction option" ("DSR"): the claims treated are rescheduled at a reduced interest rate with a 14-year repayment period including 8-year grace. -"Commercial option": the claims treated were restructured at the appropriate market rate over a longer period (25-year repayment period including 14-year grace). This was a non-concessional option.	33.33%
1990	Houston terms	For highly-indebted lower-middle-income countries with GDP per capita smaller than $2995; high indebtedness (defined as reaching at least two of the following three criteria: debt to GDP higher than 50%, debt to exports higher than 275%, scheduled debt service over exports higher than 30%); have a stock of official bilateral debt of at least 150% of private debt: This new treatment granted three substantial enhancements with respect to classic terms: - Non-ODA repayment periods are lengthened to or beyond 15 years and ODA repayment periods are lengthened up to 20 years with a maximum of 10-year grace; - ODA credits are rescheduled at an interest rate at least as favorable as the original concessional interest rate applying to these loans, over 20 years with a maximum 10-year grace. This rescheduling usually results in a reduction of the net present value of the claims, as the original concessional rate is smaller than the appropriate market rate. -Debt swaps can be conducted on a bilateral and voluntary basis.	0%
1991	London or Enhanced Toronto terms (later replaced by Naples terms)	Concerning non-ODA credits, they were cancelled to a 50% level; implemented through one of the four following options: -"Debt reduction option" ("DR"): 50% of the claims treated were cancelled (after possible topping-up), the outstanding part being rescheduled at the appropriate market rate according to standard table "A" (23 years repayment period including 6-year grace and progressive payments). -"Debt service reduction option" ("DSR"): the claims treated were rescheduled at a reduced interest rate according to standard table "B1" (23 years repayment period with progressive payments). -"Moratorium interest capitalization option" ("MIC"): the claims treated were rescheduled at a reduced interest rate according to standard table "C1" (23-year repayment period including 6-year grace and progressive payments). -"Commercial option": the claims treated were restructured at the appropriate market rate over a longer period (25-year repayment period including 14-year grace). This was a non-concessional option. Concerning ODA credits, they were rescheduled according to standard table "D" (30-year repayment period including 12-year grace and progressive repayment). - London terms also included the possibility for creditor countries to conduct, on a bilateral and voluntary basis, debt swaps with the debtor country.	50%
1994	Naples terms	The new terms, granted two substantial enhancements with respect to London terms, and were implemented on a case by case basis: For the poorest and most indebted countries, the level of cancellation was at least 50% and could be raised to 67% of eligible non-ODA credits. Creditors agreed in **September 1999** that **all** Naples terms treatments would carry **a 67%** debt reduction. The repayment periods for the "debt service reduction option" and ODA credits were lengthened to 33 years (with progressive payments) and 40 years respectively. Stock treatments would be implemented, on a case-by-case basis, for countries having established a satisfactory track record with both the Paris Club and the IMF and for which there was sufficient confidence in their ability to respect the debt agreement.	50% & 67%

Date	Terms	Description	Stock Reduction
1996	Lyon terms (later replaced by Cologne terms)	The Paris Club creditor countries, in the framework of the initiative for "Heavily Indebted Poor Countries" (HIPC), accepted to raise the level of cancellation up to 80% for the poorest countries with the highest indebtedness.	80%
1999	Cologne terms	Cologne terms are implemented on a case by-case basis. To qualify for these terms, debtor countries must be eligible for Naples terms and: - (i) Have a sound track record with the Paris Club and continuing strong economic adjustment; - (ii) Have been declared eligible to the enhanced HIPC Initiative by the boards of the IMF and the World Bank. The level of debt cancellation required to achieve debt sustainability from each creditor is calculated by the international financial institutions based creditors' relative exposure in net present value terms of total external debt, as defined under the framework of the HIPC initiative.	90%

The Evian Approach's main aim is to formalize the treatment of sustainability problems of non-HIPCs, and to provide a framework for analysing their debt condition. Initially, there was a certain degree of confusion as to whether the announcement of the initiative meant new terms of treatment. In fact, from a conceptual point of view, the key novelty in the Evian Approach is creditors' focus on long-term debt sustainability rather than on exclusively providing short-term debt relief. In terms of new procedures, this becomes evident as the first step in the debt reorganization becomes the definition of the debt problem in terms of whether the inability to pay is due to a transitory liquidity problem or a whether the debtor faces a sustainability problem. In the case of liquidity problems, the Paris Club will continue using the existing terms, i.e. Classic and Houston Terms. In case that the debtor is faced with a sustainability problem, the range of mechanisms to be applied is extremely broad, and will include write-offs, extended use of debt swaps, and changes to the cut-off date. By using a combination of already existing terms and practices, no new terms of treatment have emerged as a result of the Evian Approach.

Besides the need to formally recognize that non-HIPC countries also face sustainability problems, the Evian approach also takes into account a number of other developments that have occurred in the financial sector in the 1990's.

First, the growing importance of private creditors increased the need for a closer co-ordination amongst different types of lenders, and under the Evian Approach a practice was introduced of discussing a debtor's position with private creditors prior to the meeting of the Paris Club. It is too early to judge whether this practice will yield better results in terms of comparability of treatment, and what level of co-ordination will be achieved with private creditors. Nevertheless, closer consultations with private creditors should be seen as a positive development. Second, the advancement made by the IMF and the World Bank in developing tools for analysing sustainability enabled creditors to use these techniques in obtaining a better evaluation of the debt situation of countries. The Evian Approach envisaged the extensive use of debt sustainability tools by both the IMF and the creditors, and the decision on the sustainability of a country's debt situation was to be made by creditors rather than by the multilateral organizations. In practice, the sustainability analysis by the IMF still plays a critical role for the final assessment on the debt position of the debtor country.

Some of the challenges in the implementation of the Evian Approach faced by creditors are the probabilistic nature of results obtained by debt sustainability models. A country judged as sustainable might still encounter a structural debt-servicing problem, which would call for another round of analysis and negotiations. Some of the technical issues still remain unclear, such as which methodology will be applied for changing the cut-off date. Furthermore, the sustainability analysis that have been prepared for the few countries treated under the Evian approach so far[8] have shown that there are still a number of issues which remain unclear. The inexistence of sustainability thresholds for middle-income countries makes it difficult for countries to judge whether they are potentially facing a debt problem, while it also makes it hard to form a judgment as to whether at a given level of debt they would be eligible for debt relief.

[8] The six countries whose debt was examined using the Evian Approach are the Dominican Republic, Gabon, Georgia, Kenya, Kyrgyzstan and Iraq.

4. Commercial debt : London Club

A) Background

Commercial bank loans to developing countries, in particular to Latin American sovereign borrowers, started expanding in the 1950's. By the mid-sixties it had become part of commercial banks' business philosophies to develop global cross-border lending operations. The business boomed during the 1970's in the aftermath of the first oil shock, as banks found themselves in a perfect intermediation position. On one side of their balance sheets banks benefited from rapidly growing petro-dollar deposits, while at the same time their oil-importing sovereign clients were suffering from current account difficulties and were in dire need of financing. Banks, awash with liquidity, offered loans at competitive rates, and as a result of these developments, external commercial debt in developing countries grew from an estimated USD 36 billion in 1972, to approximately USD 180 by 1979.

During the 1960's and early 1970's there were occasional cases of a sovereign debtor experiencing balance of payments difficulties. Banks viewed these problems as localized, country specific issues, which did not endanger their balance sheets, whereas the broader financial community did not see these isolated balance of payment difficulties as representing a systemic risk. In retrospect, it is clear that the international financial community showed a lack of thorough understanding of the debt problems facing developing countries, and has overestimated these countries' ability to adjust to external shocks. There are a few notable exceptions to the prevailing sense of over-confidence in the robustness of the global financial system prior to Mexico's 1982 default and the beginning of the debt crisis. In a 1977 speech, the Federal Reserve Board Chairman Arthur Burns[9] expressed concern about banks' large exposure to developing countries, and pointed to the need of enlarging official sources of balance of payments financing for developing countries in order to decrease the commercial banks' need to continue financing current account deficits.

By the early 1980's, which witnessed a series of defaults, the rescheduling procedure for commercial bank debt was already in place. It had developed organically in the mid-seventies as a result of commercial bank negotiations with Peru and Zaire in 1976, and later with Turkey, Sudan and Poland. As a result of these initial operations, the commercial bank rescheduling process got the name London Club, as the meetings between commercial banks and Zaire, Turkey, Sudan and Poland took place in London, and English law governed most euro-currency loans which formed the bulk of rescheduled amounts. However, as opposed to the Paris Club, which is a formalized name for meetings of official bilateral creditors, the London Club remains an informal connotation. In financial circles, the gathering of representatives from commercial banks for negotiations with a debtor country is referred to as a meeting of the Bank Advisory Committee, or Steering Committee, or Coordinating Committee. Moreover, as opposed to the Paris Club, which has a permanent Secretariat based in the French Treasury, the London Club has no such permanent structure. The name London Club is also misleading as most of the meetings between commercial banks and creditors in fact took place in New York during the 1980's and early 1990's, which witnessed the peak of London Club activity with approximately 200 deals reached during this period.

[9] See U.S. house Committee on Banking, Finance and Urban Affairs (1977)

B) Debt restructuring

The defaults during the 1960's and 1970's did not represent a systemic risk to the financial system, as banks were well supplied by ever growing deposits form oil exporting countries and a good income stream from the majority of their loans to developing countries. As a consequence, all the debt restructuring deals done during that period involved refinancing, where banks extended fresh loans to borrowers facing difficulties in order for them to continue paying interest on their loans. When the Mexican government announced a moratorium on its payments in 1982, and other countries faced increasing debt servicing difficulties, the response of commercial banks was to continue the same refinancing operations that they conducted during the previous two decades.

Throughout the 1980's, banks continued with refinancing operations, which were sufficient to deal with liquidity problems that had prevailed during the previous decade. However, the newly arisen situation called for more far-reaching measures that could not be solved by repetitive rescheduling and new financing while leaving debt stocks of major borrowers unchanged. It was not until May 1987, when Citibank announced that it is making provision equivalent to twenty five percent of it exposure to developing country borrowers, that banks started realizing that debtor countries would be unable to grow out of their problems and that a significant adjustment to debt stocks would have to be envisaged. Soon after Citibank's decision, other banks began setting aside provisions for losses on their developing country loans, and by 1988, those were approximately equivalent to fifty percent of their loan portfolio to distressed sovereign borrowers.

Mexico was the first country to benefit from an experimental debt reduction effort in 1987. It involved an exchange of old debt for a lower amount of zero-coupon U.S. fixed income instruments, and produced a USD 1 billion debt reduction. This deal showed that there is a potential for debt reduction provided that old debt is exchanged for a better quality instrument. The Brazilian and Chilean deals the following year introduced new instruments into the exchange of old debt, such as exit bonds convertible into local currency, debt for equity swaps and buyback operations. Yet, although these deals marked some progress in the sense that they opened the way for debt reduction, their scope was not sufficient to lead to an exit from the debt problem facing a number of developing countries.

By the late 1980's, two major characteristics of the debt situation had become clear to creditor country governments: first, that the debt problem was structural and debtors needed to benefit from important write-offs in order to return to a sustainable situation; and second, that a programme for reducing the commercial bank debt could not solely rely on market based mechanisms, but that official enhancements were required to secure the success of negotiations between banks and debtors. These principles were the basis of the Brady Plan announced in 1989, where for the first time public funds were to be used as part of debt reduction schemes, either in support of buy-backs or for purchasing zero coupon bonds, which were used as collateral against the payment of obligations stemming from the newly issued bonds. Second, banks were pressured to conclude restructuring deals, mainly through the suggestion that they waive the negative pledge and sharing clauses, which tended to slow down the negotiations on voluntary debt reduction. In addition, interventions during the negotiations between banks and debtors by US Treasury officials tended to further show the commitment of the US Government to debt restructuring deals being concluded. Lastly, a formal change in IMF's policies occurred under the Brady Plan, permitting the IMF to disburse funds to a debtor country prior to financial assurances from private creditors that negotiations on debt restructuring had been completed. This shift in policy, known as "lending into arrears", had the effect of strengthening the negotiating position of debtors, as they were no longer cut-off from financing during their negotiations with banks. Moreover, as commercial banks were fully aware of the decreased pressure for debtors to reach a rapid deal, their own position during negotiations shifted towards a more conciliatory stance. The 1990's witnessed a series of debt restructuring deals based on the Brady Plan, and by the end of the decade commercial bank debt represented a minor share of external debt of developing countries.

While the 1990's were a success in terms of resolving the commercial debt crisis, they also created the seeds of the debt problems that came to haunt the international financial markets by the end of the decade. The improved external position of a number of middle-income countries coupled by the resumption of domestic growth and a conducive global economic environment, led to the rapid growth of bond issuance as the primary source of financing for development. As the late 1990s have shown, this has opened a whole new set of problems for debt restructuring, and again highlighted the need for an all-encompassing mechanism for resolving debt problems.

5. Bond restructuring

The Argentine crisis has re-opened the question of efficient debt restructuring and the challenges this poses for the international economic system in the absence of a comprehensive debt reorganization structure. The concern that has come to the forefront of international debate following the Argentine default has been the creation of a more robust response mechanism for dealing with the emergence of a financial crisis as a result of a default on privately held debt. The Argentine type of financial shock has underlined the need for the development of an orderly international mechanism for solving sovereign debt default. With hindsight, it would seem that it would have been in the interest of both Argentina and the bondholders to seek an earlier resolution to the crisis within a well established and internationally recognized structure.

In 2001, in the context of a looming crisis in Argentina and Turkey, and a successful litigation by a holdout creditor of Peru, IMF's first deputy managing director Anne Krueger launched the idea of creating a Sovereign Debt Restructuring Mechanism. By 2002, the IMF began working on developing a formal proposal for the creation of a Sovereign Debt Restructuring Mechanism (SDRM), which would avoid prolonged and costly private debt reorganizations. The SDRM's key features were:

- A large majority (supermajority) of creditors would be required to vote for a restructuring agreement in order for it to be accepted.
- Special provisions were to be set under the mechanisms to deter disruptive litigation by creditors
- A mechanism was to be developed giving creditors assurances that the debtor is negotiating in good faith
- Creditors could agree to give seniority and protection from restructuring to fresh private lending
- Transparency requirements were to be established

Under the proposal, the IMF was to play a key role in the resolution of debt crisis, through issuing a formal judgment on the sustainability of a country's debt. It was also envisaged that another body would be set up to arbitrate disputes between creditors and debtors in instances where a debt restructuring was deemed necessary.

In conjunction with the work on SDRM, the IMF adopted a so called "twin-track approach", where it also supported further analysis of the effects of the incorporation of Common Action Clauses (CAC) into newly issued emerging market bonds. The key difference between the two approaches is that the SDRM was statutory, with a much broader approach to the debt of developing countries. On the other hand, CACs were easier to implement, as they were used by a number of developed country issuers, but were more limited in their scope, since they apply to only the class of bonds to which they are attached.

The focus on working on two different proposals was the result of two prevailing views on the way to move towards a more orderly resolution of debt crisis. The first idea, that a formalized mechanism needs to be put in place was termed the "statutory" approach, whereas the second, based on market mechanisms and non-binding co-operative arrangements was termed the "contractual" approach.

As the discussions on the pros and cons of each approach were ongoing, in 2003, Mexico was the first emerging market issuer to launch bonds with collective action clauses. Of all the various clauses that come under CACs, Mexico retained only one, namely the provision that there needs to be a 75% threshold to amend the key contract terms agreed upon at the time of the launch of the bonds. Mexico's launch of bonds with CACs brought a de facto end to the debate as to whether emerging market issuers should work towards the development of the SDRM or use CACs. This was clearly reflected in the statement by the US Treasury Secretary, John Snow, at the April 2003 meeting of the International Monetary and Financial Committee, when he announced that it is "neither necessary nor feasible to continue working on the SDRM".

Mexico's issue was a success. It was oversubscribed, and it alleviated one of the main fears related to CACs, namely that their use would increase the cost of borrowing to developing countries. Prior to the Mexican bond issuance, the sceptics on the use of CACs had argued that by attaching such a clause an issuer would signal his doubts as to the ability to service the bond, and that investors would require a premium on such bonds. The market response to Mexico's issue dissipated such qualms, and since 2003 the number of emerging market issuers using CACs has continued to grow.

The abandonment of the SDRM gave rise to the development of a less formal approach to creating a codified set of international procedures. Under the aegis of the G-20, the Banque de France and the Institute of International Finance started actively working on the development of the Code of Conduct, whose proclaimed aim was to facilitate the dialogue between creditors and debtors and improve the prospects for an orderly and rapid resolution of debt crisis. It was decided early on, after consultations with issuers and creditors, that the Code should be voluntary. However, a number of issues were identified needing further work in order to reach agreement, such as the scope of the code of conduct, the possible role of the IMF, the need for a monitoring body, and the role and nature of creditors' committees in pre-default and default situations.

The discussion on the Code of Conduct, although lengthy and complex, finally gave rise to a document entitled "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets", which was endorsed by the Finance Ministers and Central bank Governors of the Group of Twenty at their meeting in Berlin in 2004. The Principles address four subject matters:

- Transparency and the Timely Flow of Information, which requires issuers to give timely and accurate information to the market on its economic and financial situation. In case of a restructuring, debtors are to inform creditors on their overall debt position and the proposed way for dealing with bonds on which the country has defaulted.
- Debtor-Creditor Dialogue to avoid restructuring, the main feature being the recommendation to explore alternative market based approaches for dealing with debt service difficulties in order to avoid default.

- Good faith actions, which postulate that issuers and bondholders agree on the usefulness of a common understanding on best practices for engagement in cases of default. Prior to the adoption of the principles, most issuers have expressed a preference for the rules of engagement not to be legally binding. The role of creditor committees is to be determined on a case-by-case basis.
- Fair treatment, which sets guidelines on a no-discrimination policy in the treatment of all affected creditors in a situation of default, and precludes sovereigns from influencing voting through their direct or indirect control of bonds, loans and other financial instruments.

As the Principles have been adopted fairly recently, it is still too early to judge their effectiveness. They do provide a framework that was lacking, but as they are non-binding, it remains to be seen how they will be implemented. For example, Argentina has expressed disagreement with a number of recommendations coming out of the Principles, and has not subscribed to them. Credit rating agencies have predicted that the endorsement of Principles by an issuer will have no effect on its rating. Some of the suggestions arising from the Principles could prove difficult to implement, such as seeking a restructuring from official bilateral creditors if a creditor is engaged in a restructuring with private creditors. Also, more work will need to be done on clarifying how automatic standstills on payments during a restructuring would be triggered.

6. Conclusion

The current system for dealing with sovereign debt has evolved as a result of successive debt crisis over the last thirty years. Each time a group of debtor countries faced an unsustainable external position, incremental improvements were made to the international financial architecture, with a particular focus on improving the mechanism for dealing with the type of debt that represented the largest share of the external debt burden of developing countries. Although one could argue that over the years an approach was developed to deal with each type of debt, the question remains as to whether the system as whole is efficient and fair.

The identification of the type of debt problem faced by a debtor, i.e. whether it is a liquidity or a solvency difficulty, and the speed with which a comprehensive debt restructuring deal with various creditors can be reached, remains unresolved. It could be argued that the dilemma of qualifying a debt problem as being liquidity driven or structural would exist both under the statutory and contractual approach. However, other issues of efficiency seem to favour the statutory approach. Under a contractual approach for resolving sovereign debt problems, there is little incentive for each individual creditor group to reach a speedy agreement, whereas holdouts and subsequent litigation remain a current practice. Far from being an abstract question of time involved in negotiating an agreement with creditors, a protracted restructuring process can have important economic costs for the debtor, while at the same time it could lead to a need for a larger write-off by creditors further down the road. In this sense, a formal, comprehensive and clear procedure for resolving the debt crisis would be beneficial to all parties.

On the question of fairness to both creditors and debtors, the current international financial architecture does not ensure independent mediation and arbitration regarding the required level of debt relief in order for a country to regain a sustainable debt position. A point that has been repeatedly raised is that this state of affairs is in stark contrast to the procedures outlined in national bankruptcy laws, where independent courts decide on the appropriate relief for companies facing payment difficulties. The idea that the international financial system should move towards such a mechanism seems to be sound both on economic and ethical grounds.

Although a statutory approach, if it were to come into effect, holds the promise of more efficient debt restructurings, a number of practical issues would need to be resolved prior to its entering into force. In the current set of proposals, it remains somewhat unclear as to what would be the best way to trigger bankruptcy type protection for sovereigns. Should it be based on a sustainability analysis? Would the IMF have the final word on judging the sustainability of a country? What would be the effect on capital markets of sovereign bankruptcy announcements? If bankruptcy was declared together with a payments standstill, what timeframe should be envisaged for the restructuring process to be completed? What should be the domestic policy responses by governments after the announcement of bankruptcy in order to avoid a run on the banks?

I believe that rather than being satisfied with the current practices for debt workouts, more work should be devoted to conceptualizing a comprehensive, fair and efficient international system for the resolution of sovereign debt crisis.