

Handling International Debt Crises: Anne Krueger's initiative - and after

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It took one Argentine peso to buy a dollar in the year 2000, but it now takes more than three. Argentina was struggling to service its external debt of more than 100 billion dollars before the currency collapse: it has now become impossible. There are no mechanisms in place to restructure sovereign debts, however, so the crisis continues with interest rates of more than 50% on Argentine dollar debt. Can the international financial system of the 21st century not be redesigned so as to handle such cases better?

One key player who believes it can is Anne Krueger, who took up her post of First Deputy Managing Director of the IMF just before the Argentine currency collapsed - in what was described as a 'slow motion train crash' because it seemed so inevitable. When she saw what was coming, Anne Krueger took the bold initiative of proposing a new Sovereign Debt Restructuring Mechanism (SDRM) to handle cases like this. The SDRM was modelled on US bankruptcy law which allows for corporate debt to be rescheduled and written down under court orders: but the debtors would be sovereign states and the role of the court would, in this instance, fall to the IMF itself. But this would require a change of the Articles of the IMF; and last month in Washington, the Governors of IMF decided not to go ahead with such a plan at this time.

With Anne Krueger's initiative on the back burner, for now, is there any Plan B? Happily, there is: it is to change the nature of the debt contracts themselves, so as to encourage creditors themselves to sort out the mess - by allowing a majority to change the terms of the bond to give the debtor more time, or even a write-down. This more decentralised, market-friendly initiative - to insert what are referred to as Collective Action Clauses (CACs) into sovereign bond contracts - is strongly backed by the US Treasury, and by long historical experience. In 1879 Francis Palmer, a London barrister, designed what he called majority action clauses for this purpose. The idea caught on and debt issued under London law has contained them ever since. The problem was that under New York law a bond typically has to specify payments 'of a sum certain, on a date certain' and the flexibility of Palmer's clauses fell afoul of the listing requirements. The rigidity of New York bond contracts is one reason for the more active role played by US courts in bankruptcy proceedings.

After the Mexican crisis of 1994/5, academics and policy-makers recommended that such contractual changes be extended to sovereigns borrowing in dollars in New York. Creditors showed no enthusiasm, however: like Shylock in the Merchant of Venice, they wanted the terms of the bonds to be enforced without prevarication. But this was not because creditors sought vengeance, however: it was because they knew that the IMF would be forced to come in with its money bags to help the debtors repay them in full! Why change a system that bails you out of your bad bets?

Anne Krueger's plan spelt the end of this charade: for here was the IMF threatening to restructure their holdings of emerging market debt, instead of bailing them out! Perhaps it is not so surprising that, this year both Mexico and Brazil have made

successful trial issues of dollar debt in New York containing CACS, showing that the restriction on the sort of debts that can be issued in New York does not apply to sovereigns after all! So Plan B is in motion. It is too early to celebrate, however. Relative to the 225 billion dollars of sovereign debt in issue, the amounts are very small – one billion dollars each for Mexico and Brazil; and there is the danger that, with Krueger’s plan sidelined, the incentive for such changes will wane and the charade will resume. Moreover, the capacity of clauses to sort out debt distress is limited (as we have argued in a recent paper*). In practice, Britain has found it necessary to develop Chapter 11 style court-ordered procedures despite the pervasive use of majority action clauses for more than 100 years!

What can be done to keep things moving? First, to keep up the incentive for continued progress, the threat of Plan A must be kept alive (and/or the threat of encouraging debtors to use what are called ‘exit consent swaps’ to restructure their debts). Without this, things could easily backslide so the bad old days of big bail outs for careless creditors owed money by desperate debtors. Second is the promulgation of a Code of Good Conduct for the players in a renegotiation. Or, even better, the creation of a forum for debt renegotiation, along the lines of the Paris Club (for long term, bilateral government debt of poor countries) and the London Club (for debt owed to banks), whose activities are coordinated with each other and with the IMF. It has been suggested that the latest addition be called the New York Club. Last of all, Argentina should surely insist on including CACs in its restructured debts.

Experience will demonstrate the benefits - and the limitations – of clauses encouraging creditors to help sort out debt crises. Then maybe, in time - like the happy of the Elizabethan drama - the IMF and the New York Club will go into business together, creating an SDRM through the back door!

* “Creditor coordination, moral hazard and sovereign bankruptcy procedures” in the Economic Journal, April 2003, also available at www.csgr.org.

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