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DEFAULT EPISODES IN THE 1980s AND 1990s: WHAT HAVE WE LEARNED?

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I. Introduction

External financing can help a country to grow faster by financing productive investment and by minimizing the impact of shocks on economic activity. Excessive debt flows, however, can be a problem for emerging market countries. As debt burden rises, a country becomes more vulnerable to stoppages or reversals of such flows and to debt crises. Historical evidence from the nineteenth and twentieth century suggests that cross-border lending to sovereigns has generally been characterized by cycles of boom and bust, and associated debt crises. Lindert and Morton (1989) find that historically foreign lending has been characterized by recurrent debt crises: in the 1820s, 1870s, 1890s, 1930s and 1980s. These debt crises episodes usually followed a wave of international lending, like the British lending spurt of the 1850s and 1860s to finance railroads in Latin America, the wave of European financing to Argentina in the 1880s, the U.S. led bond financing boom of the late 1920s, and the bank lending spurt of the 1970s that recycled petro-dollars from the first oil price shock of 1973 to developing countries. However, the severity of crises and the response of creditors and borrowers to the crises has varied.¹

Not surprisingly then, recent day debtor countries are encountering debt problems, just like their historical counterparts. What is surprising though, is that the frequency and, perhaps, intensity of these crises seems to have risen. Since the early 1980s, groups of emerging market economies have experienced many episodes of international capital market closure, as investors have been unwilling to roll over amounts coming due or to provide additional financing. Standard and Poor's survey of default episodes finds 84 events of sovereign default on private-source debt between 1975 and 2002 (Annex 1). While S&P's definition of default is somewhat broad, ranging from missed interest and or principal payments as well as outright repudiation, it points to the relatively large incidence of payment difficulties in recent periods.² This contrasts with the experience of the nineteenth century, where debt difficulties were confined to relatively few countries. Indeed, Bordo and Eichengreen (1999) estimate that for a randomly selected country the probability of experiencing a crisis in a post-1973 year is twice as high as in a pre-1914 year. The largest incidence of defaults, however, occurred in the 1930s, following the lending boom of the 1920s.³

Debt crises can have potentially substantial costs to the economy in terms of large output losses, higher unemployment, and slippage on poverty alleviation. Hutchinson

¹ Also see Eichengreen and Fishlow (1996).

² The increase in frequency of defaults beginning in the 1980s may have to do with the fact that there was a new wave of lending in 1974-81, whereas there was a near hiatus in foreign lending to developing countries in the period 1930 to 1973.

³ See Bordo and Eichengreen (1999), Eichengreen (1989) and Eichengreen and Fishlow (1996).

and Neuberger (2001) place the cumulative loss of output from the currency and balance of payment crises over 1975-97 at an estimated 5-8 percent. Barro (2001) finds that for a currency-cum-banking crisis output growth is lower by 2 percent a year over 5 years.⁴ Sturzenegger (2002a) obtains similar results when looking at the output costs of defaults in the 1980s. Controlling for other factors that may explain growth performance in the aftermath of a default, he estimates the average cumulative drop in output, that can be associated to the default decision, to be 4 percent over the 4 years immediately following a default. This number is larger if defaults come together, or are responsible, for either currency or banking crises. These costs arise because of several factors. Important amongst these is the macroeconomic adjustment in response to the lower availability of financial resources, and therefore larger net transfers to creditors. Also important, is the potential for default to severely disrupt the domestic financial system. Prior to default there may be an effect on the financial sector, as agents become aware of the risks of maintaining their deposits in a system highly exposed to government bonds, this leading in general to bank runs at the time of the default decision. Post default, long drawn out debt negotiations between debtors and creditors also hinder the recovery of the financial sector, especially where financial systems are weak, impairing overall confidence in the financial system and the government.⁵ The potential for default to adversely affect other international arrangements like trade relations, are another source of economic costs.

Given the fact that debt payment problems are far from uncommon in emerging market economies, and the associated high costs of debt crises, an orderly and quick resolution of crises is desirable. Recognizing the market inefficiency arising from the collective action problem of private creditors and the systemic risk posed to the international financial system by banks' exposure to defaulting countries, the debt resolution frameworks of the 1980s and early 1990s have involved official intervention either by multilateral agencies like the IMF or creditor countries.⁶ This type of "three-party" involvement contrasts sharply with the earlier periods, where there was little or no creditor government intervention in debt resolutions.⁷ While the focus in the 1980s and

⁴ The reduction in economic growth was more severe for the crisis countries of East Asia crisis during 1997-98.

⁵ Debt negotiations can be protracted. Fernandez-Ansola (1995) find that it typically took five years of negotiations (and sometimes over 10 years) to reach a debt restructuring agreement on defaulted bonds in the 1930s. More recently, such protracted negotiations were also common: it took almost ten years for the debt crisis of the 1980s to be resolved.

⁶ See Rogoff and Zettelmeyer (2002) for a review of sovereign bankruptcy proposals.

⁷ See Eichengreen and Portes (1995) and Eichengreen and Fishlow (1996). In the 1800s and 1900s, bondholders responded to debt crises by forming committees to represent them in negotiations with sovereign debtors. Initially, these committees were set up in an ad hoc manner to negotiate individual sovereign defaults. Once an agreement was negotiated and approved by bondholders, the committee was liquidated. Often, more than one committee was set up to negotiate restructurings, leading to competition among committees. This system suffered from problems of high administrative costs and the scope for debtors to play one committee against another. This system was replaced by the establishment of the Corporation of Foreign Bondholders in the United Kingdom in 1868. In the mid-1930s, the United States established the Foreign Bondholders Protective Council. Although creditor governments created formal

early 1990s remained on addressing the collective action problem of creditors, the approaches to dealing with debt crises have changed quite radically. The approach to dealing with debt crisis in the 1980s was a formal framework that essentially involved a re-profiling of debt service to provide cash-flow relief to the debtor and availability of new money from creditor banks. This approach was designed to address a liquidity problem as opposed to resolving a sustainability issue. The recognition that persistently high or rising debt burdens in the 1980s were indicative of insolvency problems rather than illiquidity, called for a paradigm shift in the response to crises and in crisis resolution. By 1990, market-based approaches to resolving debt crisis had gained favor. Thus, the Brady Plan provided a formal mechanism for restructuring loans. The Brady Plan recognized the loss of value of nonperforming debt, as well as the issue of sustainability of debt and the need to provide an exit strategy for countries from a debt trap. The Brady Plan was generally viewed as a success as restructuring countries were able to return to capital markets.

The dramatic shift from bank lending to bond financing in the 1990s, altered the international financial structure. The default episodes in the second half of the 1990s increasingly involved bonds as opposed to loans, and the latter part of the 1990s witnessed several bond workouts.⁸ Unlike loan restructurings, no formal mechanisms for sovereign bond workouts were established. This is most likely because the risks posed by the underlying credit events were not viewed as posing a systemic risk to the international financial system. Instead, markets have addressed the issues of bond workouts on a case-by-case basis, and essentially without intervention by creditor countries or multilateral institutions. Two approaches to sovereign bond workouts have been followed: voluntary and involuntary or concerted. Voluntary exchanges involve debt that is being serviced, although default could occur, while involuntary exchanges involve defaulted debt. Voluntary exchanges typically re-profile debt service, but do not lower the nominal value of debt, and when they impose NPV reductions, they usually do so by a small amount. A concerted approach, by contrast, will likely involve a haircut (either in capital or interest) for investors and a subsequent debt reduction for the debtor.

The current framework can best be described as one of muddling through. While the beginning of the 1990s saw a radical change in the approach to dealing with debt crises, the more recent debt crises have not evoked a similar response. In moving forward on approaches to debt restructuring, there appears to be broad support for incremental change-type solutions as opposed to sweeping solutions – i.e., those that radically overhaul the international financial architecture. Moreover, market participants are seemingly relying on market solutions to cope with the difficulties introduced by newer financial structures. Thus, voluntary, market-friendly approaches to debt restructuring - such as the inclusion of collective action clauses (CACs) in sovereign

entities to facilitate sovereign debt renegotiations, they were usually not active participants in the negotiations.

⁸ The Mexican Tesebono crisis of 1994-95, was the first big debt crisis of the bond-financing era. As bondholders refused to rollover maturing tesobonos, a large financing package (\$49 billion) involving the US Treasury, IMF and other bilateral creditors was cobbled together to assist the country to avert a debt workout.

bond contracts – are increasingly being viewed as a step forward in improving the current debt restructuring process.⁹ This, despite the concern that CACs would likely impose higher borrowing costs (especially on weaker credits) and lower overall financial flows to emerging markets. Collective action clauses have begun appearing in several recent sovereign bond issues. For example, this February, Mexico became the first major emerging market borrower to issue a bond with CACs under New York law. The CAC would allow a majority of 75% of bondholders to make wide-ranging changes to the terms of the bond contract in the event of a restructuring. Several other countries have since issued bonds featuring CACs, pointing towards growing market acceptance of CACs, among them bonds issued after Uruguay’s debt exchange. By contrast, the IMF’s sovereign debt restructuring mechanism (SDRM), which embodies an international bankruptcy procedure to facilitate debt workouts and calls for changing IMF Articles to override some aspects of domestic law, might be perceived by the international community as a less viable option at this time. While CACs address the creditor coordination problem for individual bond issues, they do not solve the problem of such coordination across bond issues (the so-called aggregation problem) or the problem of creditor coordination for an existing stock of debt (the so-called transition problem). Thus, it remains to be seen whether CACs will be enough to resolve debt crises or whether additional mechanisms will be needed.

The principal focus of this chapter is on sovereign defaults on external debt in the 1990s and the lessons that have been learned. The rest of the chapter is organized as follows. Section II explains the meaning of debt default, why countries default on their debt obligations, and the benefits of restructuring debt. Section III examines the approaches to resolving sovereign debt crises in the 1990s, and compares these approaches with the debt restructuring framework of the 1980s. Section V offers some lessons for the future.

⁹ In a Plenary Statement at the 2003 Annual Meetings of the Bank and the Fund, U.S. Treasury Secretary John W. Snow noted that, “... We have been making great progress in strengthening the international financial system. Collective action clauses in sovereign debt are now the market standard.”

Section II: The theory of debt default and debt restructuring

What is debt default and why do countries default?

Debt default. Debt default occurs when a borrower does not meet a debt payment obligation, i.e. fails to meet the terms of a contractual agreement. Thus, nonpayment of principal or principal and interest as well as outright debt repudiation qualify as a default. This definition is useful for comparisons of default episodes across different time periods.

Although the focus of the paper is essentially on sovereign defaults on external debt to private creditors, public and private sector defaults that bring off-balance sheet liabilities onto the government's balance sheet are also included. Sovereign defaults on external official debt – i.e. bilateral and multilateral – are not addressed here.

Why do countries default? Sovereigns default because they can't meet their contractual obligations or because they don't want to meet their contractual obligations. Amongst those debtors that can't pay their obligations are (1) those that can't pay now and (2) those that can't pay over any reasonable time period. Understanding sovereign debt defaults is complex, and issues of liquidity, solvency, and unwillingness to pay need to be addressed when evaluating the incentive for sovereigns to default.

Liquidity problem. An economy faces a liquidity problem when its debt liabilities coming due in a given period exceed its liquid foreign currency assets, including funds that it has or can borrow. That is, an economy faces a cash flow problem, although it might be solvent in the long run. Liquidity problems generally emerge when there is a sudden change in investor sentiment that results in a sharp stop or reversal of capital flows by nonresidents or in capital flight by residents. Consequently, the economy is unable to meet its immediate external obligations.

Sustainability problem. A solvency problem, by contrast, is when the economy may never be able to service its debt out of its own resources. Thus, the maximum discounted sum of current and future trade balances is less than its current outstanding debt. A solvency problem implies that the balance of payments is unsustainable over the medium- to long-term horizon. While a solvency problem implies a liquidity problem, it is possible for a liquidity problem to arise independently of a solvency problem. Distinguishing a liquidity problem from a solvency problem is not necessarily easy. While it is possible to draw a distinction between illiquidity and solvency in theory, it is difficult to distinguish between these two phenomenon on the basis of observable consequences.

Unwillingness to pay. A country may decide to stop servicing its debt well before it is insolvent. Since external debt service payments reduce current income and reduce welfare, a country may think it can improve welfare by repudiating (not servicing) its debt. The chosen decision not to pay is highly controversial. While debt payments fall, at least in the short run, there are other effects (output contraction, financial crises, etc.) that make the welfare decision all but unambiguous.

Does it matter whether the nonperforming debts of sovereigns are restructured?

Why do countries repay debt? The economic literature on debt recognizes the inherent problem of moral hazard in uncollateralized borrowing arrangements by debtor countries. This lack of collateral suggests that there must be some alternative incentive that prompts sovereigns to repay obligations. The question that researchers have asked is why do sovereigns ever repay their debt?¹⁰ Eaton and Gersovitz (1981) argue that sovereigns repay debt because future lending to the sovereign is dependent upon good repayment reputation. Bulow and Rogoff (1989) argue that good reputation is not enough to explain lending to sovereigns. They believe that lending is possible because of direct sanctions that creditors can impose on sovereigns. The importance of reputation versus direct sanctions has implications for debt contracts and debt forgiveness. Bulow and Rogoff conclude that if reputation does not matter, then debts that are forgiven will be forgotten by the market, and a debtor country should try to negotiate as large a debt reduction as possible.¹¹

Cole and Kehoe (1992) extend Bulow and Rogoff's model to assume that at any moment a country enjoys many types of trust-type relationships (e.g. trade), and that a country's debt relationships have implications for these other relationships. It then follows that a breakdown in a debt relationship will have negative outcomes for other relationships. Cole and Kehoe use this model to explain why countries repay debt, even when there are no direct sanctions.¹²

The one observed economic cost of default is protracted loss in output in defaulting countries. Dooley (2000) suggests that the potential for crises and output losses provide an incentive for sovereign borrowers to repay.¹³ It is this element of the

¹⁰ Also see Eaton and Fernandez (1995) and Friedman (2000) for a comprehensive review of the literature on this issue.

¹¹ Thus, Lindert and Mortin (1989) and Eichengreen (1989) find that historical evidence does not show that countries that defaulted were shut out of capital markets (for several years in the future) to any greater extent than countries that continued to pay their debts. Indeed, in the 1930s both good and bad creditors were unable to borrow. However, there is some recent evidence by Reinhart, Rogoff and Savastano (2003) suggesting that a borrower's history matters. The study finds that countries that have experienced serial default might be more vulnerable to a debt crisis as debt burden ratios rise. Thus "debt intolerant" countries have lower "safe" debt burden thresholds than countries with no history of debt defaults. Weak internal institutions – namely, financial systems and fiscal structure – are behind the debt intolerance. The study finds that while countries can graduate from debt intolerance, the process is slow and involves strong adherence to structural reforms and to keeping low debt ratios low over a long period. Countries with serial defaults thus face higher borrowing costs than those without. Similar results are obtained by Ozler (1992, 1993).

¹² See also Rose (2002) for an empirical analysis of this issue.

¹³ Dooley distinguishes between strategic default and unavoidable defaults, i.e. defaults that are a result of bad luck. His view is that if the IMF can distinguish between strategic and bad luck defaults, and support countries in their negotiations with private creditors in the event of bad luck defaults, this will be beneficial in terms of reducing the dead weight loss associated with such a

international financial system that makes international lending possible. Without the threat of output losses, international lending might not be possible. Thus, creditors have an interest in structuring contracts so that creditor coordination is difficult and, therefore, renegotiating contracts is difficult (making it less easy for the borrower to default). This is accomplished through equal sharing clauses, where payments made to any one creditor can be claimed by other creditors that are not being paid. Unanimous or near unanimous approval for changing payment terms on a contract are another means by which contract renegotiation are made costly.

Rescheduling and restructuring sovereign debt. Although sovereigns have incentives to repay, debt defaults do occur. The resolution of debt crises has involved debt relief ranging from a mere rescheduling of debt service payments to conversion of nonperforming debt into new debt with a lower debt service burden to debt write downs. The incentives for lenders and borrowers to reschedule or restructure obligations are quite different. The incentive for lenders to negotiate debt restructurings is a wish to recover as much as possible of the value of defaulted debt. Since the unilateral penalty, in terms of seizure of assets, that a lender can impose on the debtor is usually much smaller than the contractual value of the debt, there is an incentive to negotiate. The debtor has the option to repudiate debt, but the potential output costs plus the direct costs in terms of seizure of assets by creditors are likely to outweigh the benefits of not paying. Thus, the debtor can benefit from negotiating as well. Both lenders and borrowers can through negotiation improve upon the outcome associated with their unilateral positions. It is these potential mutual gains that motivate debt renegotiations.

Even among creditors, banks behave differently from bondholders.¹⁴ This is because banks have relationships with lenders, and this relationship is valued because it assists in better evaluating borrowers' credit risk. A better understanding of risks means that banks may be more willing than bondholders to restructure debt. Also, banks may not immediately mark to market and they have more control over the value they can assign a nonperforming or potentially nonperforming asset than do bondholders, who are required to mark to market on a daily basis. Since bank balance sheets are not immediately affected by nonperforming loans, bank lenders may have more of an incentive to try to restructure debt than do bondholders.

There is also the issue of collective action problem among creditors. The free rider behavior problem and the possibility of litigation by holdout creditors give rise to coordination difficulties among creditors. So even if all creditors are better off working together, individual creditors might be convinced that they can do better by not participating in the debt negotiations, and holding out for a better individual outcome. Thus holdout creditors could reject a restructuring and take legal action to obtain better terms. They may also bet on a successful conclusion of the restructuring, because this

default. Eichengreen and Portes (1995) also recommend that the IMF provide assistance in the case of self-fulfilling crises as opposed to crises originating from weak fundamentals. Both studies acknowledge the difficulty of distinguishing between these two types of crises, however.

¹⁴ Friedman (2000).

reduces the relative importance of their claims and increases the likelihood of a favorable settlement. This is the mechanics by which so-called vulture funds operate.¹⁵ However, while sovereigns can now be held legally accountable for their commercial contracts with foreign counter parties in the same manner as private parties,¹⁶ accessing assets that can be attached is difficult.^{17,18}

The incentives for borrowers to reschedule or restructure are to minimize the output and other economic costs of a default and to improve the country's debt burden. Borrowers benefit from restructuring because it helps them to regain access to markets for financing trade and investment, as well as to lower their cost of funds. The costs of a default are likely to be lower, the more orderly and quick is the restructuring. Of course, any improvement in country creditworthiness assumes that there will be no repetition of the default. For a debtor country, the main objectives of any debt operation are to:

- achieve cash-flow relief, i.e. re-profile debt payments to avoid short-run financing needs;

¹⁵ Contrary to what is sometimes believed, vulture funds generate strong stabilization forces by buying a country's debt when it is very cheap. While the US courts do not allow the purchasing bond issues for the sole purpose of suing the creditors, this objective is unverifiable and thus its bite as a deterrent for vulture funds rather limited.

¹⁶ See Buchheit (1995, 1997).

¹⁷ We believe the threat of litigation has been grossly overstated. Roubini (2002) considers a number of reasons for why the risk of litigation is less than what has usually been considered. The most important are:

- 1) Unilateral exchange offers have turned out to be very successful, with large participation.
- 2) Exit consents dilute the benefits of a holdout.
- 3) Sweeteners associated to the exchange can be used to entice all bondholders.
- 4) It is not clear that a holdout will be able to recover the full value of its liabilities. As long as the exchange provides mark to market gains there are ample incentives to participate.
- 5) The risk of the new instruments may be lower, increasing the perceived value of the newly issued instruments and providing incentive for participation.
- 6) Large financial institutions and large players have an incentive to keep a good working relation with the government and thus avoid litigation.
- 7) The Elliot decision (vis-à-vis Peru) will probably not hold if challenged in court.
- 8) The use of CACs can be effectively used to reduce the benefits of litigation.
- 9) Vulture funds have all the incentives to see a successful exchange in order to increase their chances in litigation.

¹⁸ Sovereign immunity historically prevented bondholders from suing sovereign debtors. The origin of this principle was an attempt to foster the well being between nations, by protecting a country from being sued in potentially biased foreign courts. With the years, and with many national companies (i.e. owned by the sovereign) conducting business in other countries, the absolute version of the sovereign immunity was left aside. The United States started to use a more restrictive approach in 1952 that was codified in 1976 in the Foreign Sovereign Immunities Act. The UK adopted similar legislation in 1978. This limited version allows suing sovereigns if engaged in commercial activities.

- achieve debt relief, i.e. to reduce the debt burden;
- avoid holdouts and litigation in the restructuring process; and
- normalize access to global financial markets.

Cash-flow relief. In order to obtain cash-flow relief, it is not necessary to default on the debt as there is always a price at which the payment profile can be adjusted in a voluntary manner.¹⁹ The most straightforward mechanism is a voluntary debt swap, by which a maturing debt instrument is exchanged for another debt instrument with similar - market value, but a different payment stream. In the case of bonds, bondholders have several reasons to participate in a bond swap. First, the new issues will certainly be more liquid, with holdouts from the exchange risking remaining stuck with an illiquid instrument after the exchange.²⁰ Second, the creditor may fear a default if the bond exchange is unsuccessful. Having said that, voluntary debt exchanges may be more feasible when fewer creditors are involved and free rider incentives are weakened.

In addition, the new bonds may include a wide range of benefits, generally referred to as sweeteners. These can be cash payouts, interest increases, or the offering of collaterals or guarantees. Also, they could arise from regulatory and tax prerogatives such as tax exemptions, tax-canceling properties, rediscount window privileges and a variety of other alternatives. Finally, sweeteners can include a number of warrants, such as exchange warrants - which give the option to increase participation in the exchange in a given time period - and extension warrants - which allow to exchange some bonds for longer maturity instruments. (Pakistan's 1999 debt exchange, for example, included no debt relief and substantial upgrades in the interest payment stream).

Cash-flow relief or voluntary debt refinancing can also be obtained by changes in regulation that increase the demand for government debt. One example, is to allow banks to use government bonds to integrate reserve requirements. Russia, Ukraine and Argentina used this mechanism to prop up demand for their debt prior to default. Governments also offered to retire debt at face value if debt is used to pay taxes or to purchase equity (for example, in privatization offers). While this implies a one-to-one reduction in tax collection, if concentrated in short-term instruments, it may create demand for short-term bond instruments, facilitating the rollover of public debt. If it includes longer maturity bonds, it can actually aggravate the short-run cash-flow problem if it reduces tax collection.

For a country that does not expect to default, allowing firms to pay taxes with bonds, allows for a substantial tax break for local corporations at the expense of bondholders (some of whom may be foreigners). If the government expects to comply with its debt, this means that for debt traded at heavy discounts, there will be sizable capital gains when it is realized that the government will pay. By allowing local corporations to pay taxes at nominal value with debt instruments, the government reduces

¹⁹ Also see Sturzenegger (2002a).

²⁰ If the new instruments provide improved liquidity they may be issued at a lower return than previous instruments yielding a NPV savings.

the risks of holding such instrument, thus giving an advantage to local firms. When a bondholder takes a loss by selling a debt instrument to the local entrepreneur at deep discounts, this effectively reduces the tax liability of the local firm at the expense of the capital loss for the bondholder.²¹

Debt reduction. The theoretical arguments for debt reduction are the debt overhang issue and the Debt Laffer curve.²² A country with a given amount of external debt has to make a choice between how much to consume and invest. Investing today will increase future output. However, some of this increased output will go towards repaying debt. If claims on future output are large, the incentive to pursue pro-investment policies may not be strong. The debt overhang problem can be easily explained using a two-period model. In period 1 the economy has debt obligations that it must repay in period 2. In period 1 the economy must decide how much to invest so as to get a return in period 2. The larger the debt in period 1, the greater will be the amount that will have to be paid out of investment returns in period 2. Thus, debt represents a tax on the resources of the economy.

The investment disincentive effect of a large debt burden are used to obtain a debt Laffer curve. The debt Laffer curve relates the levels of expected debt repayment with debt levels. The slope of the Laffer curve is the change in expected repayment with a change in initial debt stock. For low initial levels of debt, the expected repayment increases by the same amount as the change in initial debt, and the slope of the Laffer curve is 45 degrees. For higher levels of initial debt the increase in expected repayment is less than the increase in debt stock. At some size of initial debt, the change in expected repayment associated with an increase in initial debt stock is zero. Beyond this point, the expected repayment falls with larger debt stocks. It follows from the above, that there is a maximum amount of debt beyond which payments on debt decline. The concepts of debt overhang and the debt Laffer curve suggest that creditors are thus better off canceling any debt (and in turn debt service) above the level of maximum repayment.

In order to achieve debt reduction, a country has to convince creditors that it cannot pay, i.e. that the market value or present value of debt is less than the face value. While creditors and debtors may have a common understanding of the sustainability of debt and the ability of a country to pay, agreeing on the appropriate market price of impaired debt may be more contentious. Also problematic, is avoiding litigation and holdouts from those creditors that choose not to participate.

Debt reduction deals usually include some short-run sweetener in order to secure creditor participation. Typical sweeteners are cash payouts and increases in the interest rates. Creditor upgrades are also possible incentives to encourage creditor participation. Payment guarantees by third parties and collateralization provide incentives to creditors as they reduce credit risk. If neither guarantees nor an upgrade in the quality of the lender are possible, an alternative is to upgrade the instrument, i.e. offering a more liquid

²¹ However, a secondary market for these instruments could develop which may allow for a sharing of the benefits.

²² See Perasso (199) and Sachs (1988).

instrument, a more reliable jurisdiction, better terms in the covenants of the issue, or instruments with tax or accounting advantages. Indexation and growth clauses, also known as value recovery rights or economic and credit-linked warrants, allow some bondholders or creditors to share in the benefits of their effort in granting debt relief. The mechanism is a clause in which the payment is associated to some macroeconomic factor such as the price of an export commodity or output growth. While these factors have not been very common in recent defaults value recovery rights remain an interesting option as they approximate bonds to shares, therefore aligning the interests of the countries and bondholders. In some cases, for example, linking the recovery value to GDP performance may carry moral hazard risks if it is the country itself that produces the national statistics, however, linking the performance to commodity prices or other well defined asset price reduces this risk significantly. The relative modest use of this instrument remains an open question. Puts and acceleration clauses are other ways of enhancing instruments.

Avoiding litigation and holdouts. The third objective is that of avoiding holdouts and litigation. One mechanism by which a country can reduce litigation risk to a minimum, is through the introduction of collective action clauses, CACs (Annex 2) . By allowing a supermajority of creditors to change payment terms, CACs make the restructuring process easier and reduce the incentives for maverick litigation.²³ CACs are more easily introduced in issues under London Law than New York Law. London Law allows for changes in the conditions of the bonds under majority ruling, whereas New York Law does not allow changing payment conditions of a bond except with unanimity, although non-payment amendments can be made. Recently, CACs have been introduced in bonds issued under New York Law.

While the literature has focused on international litigation, domestic litigation should not be disregarded. If a country defaults on its own citizens, these have the right to pursue the case in domestic courts, and, barring the case of a completely corrupt judicial system, they may have certain power to obtain favorable court rulings. Notably, in this case, attachments may be much more feasible. For example, Argentina has faced a number of legal actions called *amparos* (protection of constitutional rights) when the government attempted to change the terms of the domestic bond exchange by changing their currency of denomination from dollars to pesos at the conversion rate 1.4 pesos for each dollar (when the market rate was closer to 3). The government used an economic emergency law to justify the swap, but the Supreme Court, in a related recent ruling regarding the deposit freeze stated that the emergency law cannot be used to wipe out property rights.²⁴ Whether the Supreme Court would take a similar stance regarding the resolution of the *amparos* relating to the domestic bond exchange is still unclear at this time. In the Argentine default the government is facing massive litigation in local courts, while foreign bondholders have been extremely cautious with only few litigation cases presented so far.²⁵

²³ See Becker et al. (2001).

²⁴ The case is *Smith contra Poder Ejecutivo Nacional*.

²⁵ Recently Rogoff and Zettelmeyer (2001) have suggested that lending should be forced through local courts in order to insure solvency, as there the legal rights of the claimants are more exposed

Conclusion. Clearly, both lenders and borrowers can potentially benefit when defaulted debt is rescheduled or restructured. The issue is whether markets are efficient and can yield orderly workouts. Namely, whether markets can overcome collective action problems among creditors. While debt rescheduling and restructuring can ameliorate payment difficulties and make both creditors and debtors better off than under a default, Friedman (2000) argues that some nonperforming debts should not be restructured. Some amount of defaults should be allowed as a market process, so that investors can better price borrower risks – i.e. *ex-ante* market efficiency. By forcing defaults to be at artificially low levels, cross-border flows are higher than they would be in an environment of higher defaults. Thus the aim of debt markets should not be merely maximizing debt flows; rather it should also appropriately evaluate risk. This suggests the need for balance between appropriately pricing risk and determining investment levels – *ex-ante* efficiency - and reducing debt burdens – *ex-post* efficiency.

Section III: Approaches to resolving debt defaults in the 1990s

Historical evidence suggests that cross-border lending to sovereigns has generally been characterized by cycles of boom and bust. Excessive lending tends to raise debt burdens and make borrowers vulnerable to sudden stoppages or reversal of flows. When flows reverse they have often resulted in debt payment difficulties and debt crises. Like their historical counterparts, recent day debtor countries have encountered debt problems and even full-blown debt crises. What is surprising, however, is that the frequency and, perhaps, intensity of crises seem to have risen (Chart 1, Table 1).²⁶ Thus, the 1980s debt crisis followed on the heels of a bank lending boom that began after the first oil shock of 1973. In 1982, in response to a substantial hike in interest rates in the US, and as new money from banks dried up, Mexico declared a moratorium on its debt, triggering the beginning of a debt crisis that lasted through the early 1990s.²⁷ Once the default in Mexico occurred, banks withdrew from other emerging markets leading to a domino effect that triggered defaults in a large number of developing economies. The debt crises lasted for nearly a decade as successive approaches were adopted in resolving the crises.

In the 1990s, lending to emerging markets was characterized by periods of high growth followed by sharp contractions or reversals of these flows. The early 1990s saw resumption in private lending that was led by bond investors. Debt flows nearly tripled

to the arbitrariness of local jurisdiction and legislation, so that foreign investors will be enticed only under very solid circumstances. Barring the experience of Russia and Ukraine, which seems to suggest otherwise, if litigation in domestic courts has a larger chance of success than in foreign courts, given the ease of attachability, then such proposal will lead to less responsible lending rather than more responsible lending.

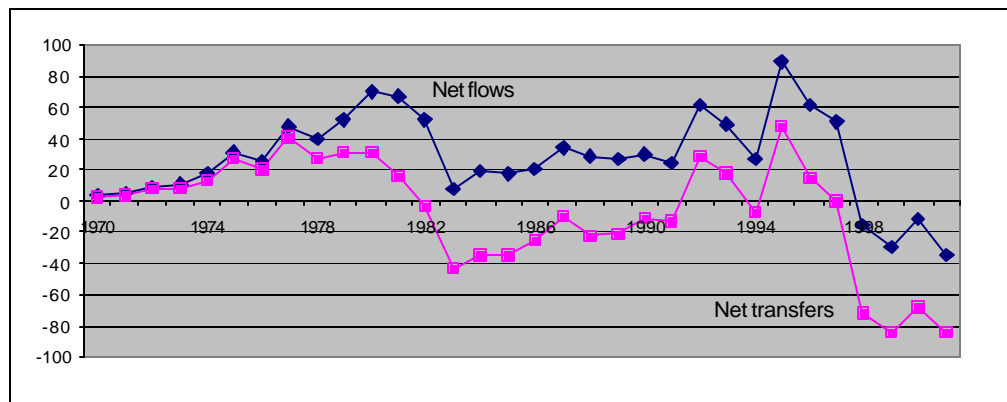
²⁶ Also see Footnote 2.

²⁷ The 1980s debt crisis resulted from a combination of factors, namely, weak economic policies in several countries in the period preceding the crisis; a bank lending boom that began after the 1973 oil shock and that was especially strong during 1979-81; and adverse global macroeconomic shocks - interest rate and commodity terms of trade.

over 1991-93, before collapsing in the wake of the Mexican Tequila crisis that occurred at the end of 1994. Flows resumed in 1995 reaching a peak of \$110 billion in 1996. Again, debt flows collapsed in the midst of the East Asian crisis of 1997 and were further affected by the debt crisis in Russia in 1998.²⁸ The crises in Korea and Indonesia led to debt rescheduling arrangements backed by sovereign guarantees for these countries (Annex 4). The crisis in Russia led to a default on domestic debt followed shortly after by a default on external debt. This marked the beginning of a string of new restructuring experiences. In the following four years, Ukraine, Pakistan, Ecuador, Argentina and Uruguay, all defaulted or had to restructure under the threat of default.

Standard and Poor's survey of default episodes finds 84 events of sovereign default on private-source debt between 1975-2002 (Annex 1), with many countries experiencing serial defaults. S&P's definition of default is somewhat broad, ranging from missed principal and or interest payments as well as outright repudiation. There is thus considerable variation in the severity of default episodes. Nevertheless, the relatively large incidence of payment difficulties demonstrates the fact that debt difficulties are far from uncommon in emerging market economies. Both rated and non-rated sovereign issuers have experienced defaults on private debt. The survey includes both external and local-currency debt defaults, although the frequency of external debt default is much higher at a ratio of 10 to 1.

Chart 1: Net flows and transfers on commercial bank and trade finance to developing countries



²⁸ These crises were mostly associated with collapsing pegged exchange rate regimes.

Table 1

Table: Volatility of private debt flows			
	1970-82	1983-89	1990-02
Private debt flows/GNI (%)			
Mean	1.77	0.73	0.93
S.D	0.71	0.23	0.89
Private debt flows/Exports (%)			
Mean		3.83	3.8
S.D		1.32	3.48

Source: *Global Development Finance*

Approaches to resolving debt defaults in the 1980s

Dealing with the 1980s debt crisis. The debt crisis of the early 80s resulted from a combination of factors. Unrealistic positive expectations in debtor countries justified significant increases in domestic absorption that led to large current account deficits financed by external borrowing. When this large increase in debt, faced a negative international environment, solvency problems became immediately obvious. The two main negative developments in the international environment were the productivity slowdown and the world economy recessions of the mid seventies and early 80s as well as the hike in interest rates that was the result of the disinflation program in the US.

When the debt crisis erupted in 1982, policymakers and market participants were acutely concerned over the potential systemic risk that it posed to the international financial system and the associated disruption of international trade and finance.²⁹ There was a realization that creditors and debtors needed to cooperate so as to allow countries to grow out of their debt problems and re-access capital markets.³⁰ A formal framework was initiated to facilitate debt agreements.³¹ The key market failure that the framework was addressing was that of coordination among creditors, i.e. collective action problems among creditors. Consequently, banks gathered in a consortium – London Club - with

²⁹ Clark (1992) shows that the high exposure of banks to developing country debt was behind the concern over the vulnerability of the international financial system. The exposure of US money center banks to restructuring developing countries at end-1982 was 215% of banks' capital and 260% of equity. The exposure of UK and Canadian banks at the end-1984 were about 275% and 195% of equity, respectively.

³⁰ As noted earlier, intervention by officials - creditor governments or multilateral institutions - in resolving debt crises was a new phenomenon.

³¹ The framework for negotiating bank debt developed in line with the Paris Club framework for official debt.

the purpose of conducting debt renegotiations. The strategy that was adopted can be thought of as having three phases.³² The common elements of the three phases were rescheduling of debt maturities to provide front-loaded cash-flow relief to debtors along with provision of new money by creditor banks. The incentives for banks to participate were that this strategy maintained the face-value of developing country claims on their books, and it also meant that they would benefit from any future improvement in countries' ability to service debt. For debtor countries the incentives were that it provided them with near term cash flow relief and new money. The 1980s new money approach was designed to address a liquidity problem as opposed to resolving a sustainability issue.³³

New money approach – first phase. The first phase was an immediate response to the Mexico crisis, and it emphasized adjustment and austerity. Under this approach, which was supported by the U.S. administration, countries adopted IMF approved adjustment programs and commercial banks rescheduled debt obligations maturing over a short period – usually one to two years - and debt in arrears. Banks also maintained short-term credit lines and provided new money commitments, which partially covered interest payments. This so-called “concerted lending” – new money packages – was designed to fill a country’s financing gap.³⁴ The feature of new money by banks did not represent voluntary lending, however. Countries were also able to access short-term bridge financing from major creditor governments. Mexico was the test case for this approach. In August 1983, the country reached agreement with its creditor banks to reschedule \$23.3 billion of maturities, and during 1983-84 Mexico also obtained two new money agreements totaling \$8.9 billion. In turn, the austerity measures adopted by the government shifted the current account from a deficit to a surplus. During 1983-84, 47 rescheduling agreements were negotiated, covering \$130 billion. Principal coming due over 1-2 years was rescheduled. The typical terms on rescheduled debt were eight-year maturity and four-year grace, with an interest margin of 1 ¾ - 2 ½ percent. A major limitation of the first phase was the focus on the near term and lack of a framework for promoting medium-term growth in crisis countries.

New money approach – second phase. The shift to a second phase began in 1984, and represented an improvement over the first phase. Now, the approach to managing the debt crisis moved from a near-term to a longer term focus with a view to normalizing bank lending to developing countries. Instead of rescheduling maturities on a year-to-year basis, the new approach advocated multiyear rescheduling - MYRAs. Under this approach, banks agreed to reschedule debt maturing within three to five years. The terms on rescheduled debt were also more favorable at maturities of 9-14 years. Banks also provided concessions in terms of narrower interest rate spreads on rescheduled debt and elimination of rescheduling fees. In turn, banks were not required to pledge new money, i.e. no forced lending. The obvious benefit to debtor countries was

³² See Brainard (1985).

³³ As we noted in Section II, problems of illiquidity and solvency are observationally equivalent, which makes it difficult to distinguish between these two types problems.

³⁴ Until 1988, IMF disbursements were conditional upon a country reaching agreement with its creditor banks on debt restructuring and new financing.

that it lowered debt servicing amounts over longer period, providing significant cash-flow relief. While IMF conditionality was still an important aspect of this approach, the economic adjustment that was required under IMF programs was less severe. Eight countries (2 agreements for Mexico) rescheduled their debt using the MYRA framework. Like the first phase, this approach lacked a focus on promoting medium-term growth.

New money approach – the Baker Plan. In October 1985, the United States unveiled the Baker Plan. The third phase of handling the debt crisis marked an important departure from the two earlier approaches in that it recognized the need for fostering economic growth. The Baker Plan advocated structural adjustment and market-oriented policies for market generating growth. Another key element of the plan was increased lending by commercial banks. In association with an IMF program, participation of multilateral organizations such as the World Bank was greatly enhanced. The Plan envisaged net commercial bank lending of \$20 billion over 1986-88 and multilateral development bank net lending of \$9 billion.

A fundamental premise of the debt resolution of the 1980s, including the Baker Plan, was that all similarly situated commercial creditor banks should be treated equally, both in terms of rescheduling of their existing exposure as to their proportional participation in new credit facilities. From a legal standpoint, this equal treatment was ensured through a series of contractual provisions in the rescheduling deals such as sharing clauses, mandatory prepayment provisions, negative pledge clauses and pari-passu covenants. However, syndication of all loans could not be compelled legally so some degree of moral suasion remained necessary. This monolithic approach implied complete ignorance on the specifics of each bank, and this, in the end, was responsible for some delays and difficulties in reaching agreements. Thus, over the years new flexibility had to be introduced in order to suit the differences both of different creditors and debtors. In all cases, however, debt forgiveness was off the table as an alternative.³⁵ In order to solve the free rider problem among commercial banks, several sweeteners were offered to those participating in the rescheduling.

Although 10 countries negotiated debt agreements with commercial banks, the level of net bank lending fell far short of the Baker Plan targets. Indeed, public sector borrowers only received \$4 billion of net bank flows. However, several middle-income countries were able to negotiate better terms.

The new money approach failed to resolve the 1980s debt crisis. The success of the new money approach in managing the debt crisis was recognized as being rather uneven. While systemic risk to the international financial system was contained, the goals of lowering the indebtedness of crisis countries and normalizing their access to financial markets was not achieved. Indeed, the main failure of this approach was that debtor countries were unable to exit from the cycle of debt rescheduling. There are several reasons for this. First, rescheduling of maturities provided cash-flow relief for a relatively short period. New money packages only partially covered interest payments on

³⁵ However, banks were slowly building provisions to exit from developing country risk exposure.

existing debt. Thus, if payment capacity did not improve quickly, additional rescheduling or new money was needed. Second, new money packages combined with rescheduling increased the stock of debt, and contributed to a debt overhang problem. Crisis countries apparently, had little incentive to grow in the face of mounting debt and debt service. Third, a continuous cycle of rescheduling deterred normalization of bank lending. Thus external finance for new investment and growth was not forthcoming. Also, by the mid-1980s, new money packages became increasingly difficult to negotiate as smaller banks were looking to reduce exposure to developing country debt. Lastly, debt rescheduling negotiations were usually long drawn out and costly. Banks had diverse business objectives, and getting all creditor banks to sign on to what was agreed by the banks' advisory committee was time consuming. For small banks there was also a free rider problem, as these banks could potentially benefit, at no cost, from the efforts of the larger banks: small banks could share in interest payments facilitated by new money, without contributing to it.

Table 2: Performance of 26 countries that rescheduled their debt in 1982-84

	Average 1970-80	Average 1981-82	Average 1983-84	Average 1983-86
Net resource transfers in bills \$US (on medium- and long-term debt)	8.0	9.6	-12.7	-16.1
Debt/GDP (in %)	26.3	44.5	61.3	63.2
Per capita GDP growth (in %) (annual change)	3.2	-2.9	-1.2	0.4

	1980	1981	1982	1983	1984	1985	1986
Net resource transfers in bills \$US (on medium- and long-term debt)	7.2	16.2	3.0	-10.4	-15.1	-21.1	-18.0
Debt/GDP (in %)	36.9	40.5	48.6	59.6	63.1	64.0	66.2
Per capita GDP growth (in %) (annual change)	4.5	-2.7	-3.1	-4.2	1.8	0.8	3.2

Table 2	
Characteristics of the new Money Approach and the performance of gdp growth and net debt transfers in default countries	
New money : approach	Formal mechanism to facilitate cooperation among debtors and creditor banks. Three-party involvement - creditor banks, sovereign borrowers, and multilateral institutions and/or creditor countries. Phase 1 1982-84 Phase 2 1984-85 Phase 3 - Baker plan 1985-89
Goal :	Address collective action problem among private creditors – free rider problem and litigation. Avert a systemic disruption of international finance and trade. Gain time for debtor countries to improve their debt-servicing capacity. Get debtor countries back on a sustainable growth path. Restore debtor countries’ access to the international capital markets.
Features:	Countries remain current on interest payments and adjust aggregate consumption and investment. In later periods the emphasis was on structural reform. No menu of options for banks. Banks reschedule amortization payments falling due and in arrears: <u>Phase 1</u> - maturities falling due in 1 -2 years were rescheduled at average terms of 8 years maturity and 4 years grace, and 1 7/8 percent interest spread; <u>Phase 2 MYRAs</u> - maturities falling due in 3- 5 years were rescheduled at terms of 9-14 years maturity and 1 3/8 percent interest spread; & <u>Phase 3 Baker Plan</u> - better terms on rescheduled debt, i.e. up to 20 years maturity and interest spreads as low as 13/16 percent. Banks maintain short-term credit lines, and extend new loans to partially refinance interest obligations. Multilateral creditors increased lending; initially IMF and then WB (under the Baker Plan). Addresses a liquidity problem not a solvency problem.
Rescheduling: episodes	47 rescheduling agreements during 1982-84, covering \$130 billion of debt. 8 MYRAs during 1985-86, covering \$81 billion of debt. 10 Baker Plan rescheduling agreements during 1985-88, covering \$165 billion of debt.
Impact on debtors	Performance for 27 countries that rescheduled in 1982-84: GDP average annual growth rate in 1970-80 = 5.8% and in 1982-84=0.57%. Debt/Exports in 1981=212% and in 1984=258% Debt/GDP in 1981=40% and in 1984=63% Transfer private external debt obligations to the public sector
Impact on creditors	Concerted lending –new money packages – by creditor banks, and multilaterals and/or creditor countries. Banks provided trade credits and bank lines. IMF lending conditional upon agreement with banks on debt rescheduling and new financing.

Results	<p>Systemic risks to banks contained.</p> <p>Repeated rescheduling by debtor countries and no exit from debt trap.</p> <p>Banks reluctant to extend new money because of risk of repeated rescheduling.</p> <p>The coordination problem among banks was resolved, but it did not effectively address the problem of new financing.</p>
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Approaches to resolving debt defaults in the 1990s

Dealing with the 1990s debt crises. The 1990s defaults were characterized by the resolution of the loan defaults of the 80s during the early part of the 1990s and bond defaults towards the end of the decade (also included are defaults through 2002). At the start of the decade, there was a growing recognition that persistently high or rising debt burdens were indicative of insolvency problems rather than illiquidity problems. This called for a paradigm shift in the response to crises and in crisis resolution. By 1990, market-based approaches to resolving debt crisis had gained favor. These approaches recognized the loss of value of nonperforming debt, as well as the issue of sustainability of debt and the need to provide an exit strategy for countries from a debt trap. A new formal mechanism for restructuring defaulted loans – the Brady Plan - was introduced. The Brady Plan was generally viewed as a success, as major restructuring countries were able to re-enter international capital markets.

At the private sector level the shift in policy favoring debt reduction had been in the making for sometime. During the later part of the decade a secondary debt market had appeared for developing country debt, trading at sizable discounts. The realization that losses had already been incurred pushed debtor countries to try to share the benefits from honoring their commitments. On the other hand, the development of the secondary market put pressure on banks that had not sold off their loans, as they feared that at some point they would be called to mark to market the value of such loans. In fact, Citibank started along this path in May 1987 by posting loan loss provisions against its LDC debt. Thus, towards the later part of the 80s, the new money approach became unstable and started veering naturally towards some kind of debt reduction. For the banks this was further enhanced by the fact that tax benefits would accrue only upon the granting of the debt relief.

Indeed, Mexico offered a preview of the Brady deal in late 1987 by offering an exchange of bank loans for a new Mexican bond with a 20 year maturity and with principal collateralized with US zero coupon treasuries. The reception to this instrument, without interest collateral, was muted. Principal discounts offered were in the order of 30% but only a fraction of the amount Mexico was prepared to exchange was subscribed. Obviously, more resources had to be put on the table to provide additional enhancements to switch out of the original loans.

In spite of having initially only partial success, in the following years the program moved ahead swiftly, with a committed support from creditor countries and multilaterals, quickly normalizing the debt situation of many countries.

The return of emerging market countries to the global capital market in 1991, started a new lending boom. Private debt flows in the form of bond financing to these countries surged. Beginning in the latter part of the decade, however, there were several episodes of bond defaults and distress bond exchanges. Most of these credit events were resolved through market-based informal mechanisms, that represent a muddling through approach. What is remarkable about these debt exchanges is that the speed with which these cases were resolved contrasts strongly with the view that sovereign bond exchanges were extremely difficult to undertake. There are several reasons behind the perceived difficulty of such bond operations, including coordinating negotiations with an increasingly large number of diverse and anonymous investors that hold bonds and the potential for hold-out investors to disrupt negotiations.

Loan defaults of the early 1990s and the Brady Plan. In a bid to overcome the shortcomings of the new money approach of the 1980s, the United States introduced the Brady Plan in March 1989.³⁶ This plan signaled a major shift in the official position to managing the debt crisis. Under the new approach, there was official support and encouragement of debt reduction packages that could resolve pending debt issues and re-open market access for many of these economies. In fact, the Brady Plan mandated multilaterals to increase lending in support of these debt operations.

The major distinguishing elements of the Brady Plan were debt relief through a menu of market-based options ranging from debt stock reduction to new money to rescheduling of principal and interest. The menu approach addressed the issue of increasingly divergent business goals of banks with exposure to developing countries. Banks could chose the option that best suited their business interests. So if banks wished to exit from the country, they could chose the debt reduction option. Those wishing to stay on and benefit from the resulting improved debt burden of the country were expected to provide new money. The benefit to debtor countries were lower debt burden through debt reduction, debt service reduction, and/or substantial extension of the time horizon of contractual relief. Lower debt burdens improved countries' prospects of exiting from the cycle of debt renegotiations. Along with a reduction in countries' debt burden, implementation of a strong, growth-oriented policy framework was critical to resolving the debt situation.

Menu approach – The menu approach addressed the issue of increasingly divergent business goals of banks. It provided these banks with a market-based menu of options from which banks could choose. The Brady deals included a number of relatively standard instruments.

³⁶ The plan is named after US Secretary of the Treasury Nicholas Brady, successor of Secretary James Baker.

Par or Discount bonds. Pars were loans exchanged for fixed rate bonds issued with below-market interest rates at par. Discounts were floating rate bonds, issued with market interest rates, but with a capital write-off. Both were backed by a US Treasury zero coupon bond for principal collateral. These bonds had long-term maturities, were expected to be very liquid, and had a long average life and bullet amortization. They represent the most common Brady bonds outstanding.

Front Loaded Interest Reduction Bonds (FLIRB's). In this case loans were exchanged for medium term step-up bonds at below-market interest rates for the initial 5 to 7 years, and then at a floating rate for the remainder of the term. These bonds provided partial interest collateral in the form of cash, with collateral rolled over for subsequent periods upon timely interest payments. While these were less liquid than the par/discounts, they had a much shorter average life, as amortization payments began ordinarily after 5-7 years.

Interest Arrears Capitalization. Commercial banks had rescheduled interest in arrears of Brazilian, Argentine and Ecuadorian debt, capitalizing the interest into new short-term floating rate bonds, called Interest Due or Unpaid Bonds –as in Brazil's IDU and Ecuador's PDI. These bonds had been issued prior to the rescheduling of principal into the Brady format.

Debt Conversion Bonds or New Money Bonds. In some cases countries were believed to have the ability to pay their foreign loans, but had so far been unwilling to service the debt. The initiation of a Brady deal was a sign of a new willingness to repay foreign debt, augmenting the creditworthiness of the countries. Thus creditors exchanged loans for bonds at par, and even provided additional funds to the Brady issuing nation, at a floating rate of interest through the so called New Money Bonds. They include short-term floating rate bonds as issued by Venezuela, Uruguay and the Philippines and carried no collateral.

The menu approach advocated by the Brady Plan allowed banks to choose the options that were most appropriate to their particular situation: their external situation in terms of the accounting and regulatory environment as well as internal situation in terms of banks' policies. The possibility that one option might be picked more often than another, thereby undermining the menu approach, was an issue. The menu approach, however, encouraged wide participation by banks in restructuring agreements.

Another perceived favorable aspect of the Brady bonds was that they were believed to have been structured as an inviolable set of instruments. Not only were they issued according to New York Law, which does not allow for bondholders to change the payment conditions of the bonds unless there is unanimity, but they included a series of provisions which made them practically default risk free. Among these provisions were (i) mandatory prepayment clauses that restrict not ratable prepayments to others, (ii) turnover clauses that require creditors receiving preferential prepayments to turn these payments over to others, (iii) the sharing clause that requires a creditor to share what he

receives with others, (iv) the negative pledge clause that requires other lenders are not to be given a preference by having assets pledged to them and (v) the acceleration clause wherein a creditor who holds defaulted debt can ask for all the debt to be paid immediately.

The Brady Plan was designed to reduce countries' debt and debt-service burdens. This improvement was achieved through permanent cash-flow relief resulting from debt stock reduction and lower interest rates.³⁷ Thus Brady-style debt restructurings lowered the PV of debt relative to the face value of the original debt. However, net transfers under the Brady Plan were not much different from those in the pre-Brady period. So while countries debt burdens improved, restructuring countries did not on average receive higher financing. This is to be expected because for a given primary balance and seigniorage, a lower debt service would necessarily imply a lower amount of new financing. There was considerable variation among countries, however. Thus, countries like Argentina and Brazil that were in nonpayment status experienced an increase in debt service payments as relations with creditors were normalized. By contrast, countries that were already paying their creditor banks, found that their debt service was reduced. While the cash-flow relief in the near term was about the same as under the Baker plan, it was the longer term improvement in sustainability of debt that was critical.

The Brady deal was considered a success. It normalized the relations between creditors and debtors and opened up a new era of resumed lending to emerging economies. While there were many factors behind the surge in financial flows to emerging markets, the resolution of the countries' debt problems is an important contributing factor to renewed flows. However, some of the characteristics of the deal, particularly the stepped up characteristic of the interest payments included in some bonds, would impose an unsustainable burden on some debtors 10 years later. In addition, the belief that the restructuring had produced default free instrument would later on also be found to have been wrong.

³⁷ The debt restructuring operations required up-front financing for purchasing collateral for bonds, repaying arrears, and buybacks. A large amount of the financing was provided by official sources, with debtor countries also making a significant contribution. Brady agreements also continued to support debt conversion schemes as a way to reduce debt burden. Under these agreements, countries typically agreed to convert a minimum level of debt into equity, among other mechanisms. Although several conversions took place at the beginning of the decade, and were important in countries like Argentina and Chile, the overall size of conversions was low.

Table 3: Performance of 17 Brady bond countries*

	Average 1983-89	1990	1991	1992	1993	1994	1995	1996
Net resource transfers in bills \$US (on medium- and long-term debt)	-19.7	-10.6	-10.2	-11.1	3.3	-6.3	1.3	1.4
Debt/GDP (in %)	54.0	47.1	46.8	42.9	42.7	39.6	41.2	38.6
Per capita GDP growth	-1.9	-2.3	1.1	1.1	2.0	3.2	-0.4	2.0
* Poland data are from 1990 and Vietnam data from 1984								

Table 3
Characteristics of the Brady Plan and the performance of gdp growth and net transfers on debt in default countries

Brady Plan :	<p>Introduced in March 1989.</p> <p>Formal mechanism to facilitate more efficient cooperation among debtors and creditor banks. Three-party involvement - creditor banks, sovereign borrowers, and multilateral institutions and/or creditor countries.</p>
Goal :	<p>Address collective action problem among private creditors – free rider problem and litigation.</p> <p>Address the shortcomings of the Baker Plan.</p> <p>Address the diverse business interests of creditor banks, i.e. some banks wanted to exit emerging markets while others did not.</p> <p>Break the cycle of continuous debt renegotiations.</p> <p>Improve countries debt-servicing capacity through debt and debt service reduction.</p> <p>Get debtor countries back on a sustainable growth path.</p> <p>Restore debtor countries’ access to the international capital markets.</p>
Features:	<p>Market-based approach recognizing the market value of impaired debt.</p> <p>Reduction in PV of debt through debt and debt-service reduction.</p> <p>Menu of options for banks recognizes the diversity of banks’ business interests.</p> <p>The choice of either debt reduction or new concerted lending, limited the free rider problem.</p> <p>Addresses a debt solvency problem.</p> <p>Debt reduction: discount bonds; buybacks.</p> <p>Debt-service reduction: interest reduction bonds or par bonds; front loaded interest reduction bonds.</p> <p>New money with or without conversion bonds.</p>
Results:	<p>18 countries have had Brady operations restructuring \$200 billion of bank claims for \$154 billion of bonds.</p>
Impact on debtors	<p>Performance of 17 countries with Brady deals: Debt/Exports in 1990=263% and in 1996=188% Debt/GDP in 1990=47% and in 1996=39% Up-front cash requirement for DDSR operations - buybacks, purchase of collateral for bond exchanges, payments on arrears.</p>
Impact on creditors	<p>IMF lending into arrears.</p>

Results	Renewed access to global capital markets for restructuring countries. Exit from the continuous cycle of restructuring. The coordination problem among creditors was resolved, as was the problem of new financing.
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Bond defaults of the late 1990s and a muddling through approach.

During the later part of the 90s several countries faced a combination of debt currency and banking crises that led to debt restructurings. In most of these cases unsustainable fixed exchange rate regimes and large current account deficits, combined with weak fiscal problems and liability dollarization, combined to induce significant uncertainties regarding the solvency of the banking and government, leading eventually to sharp contractions in capital flows, and thus to an inability to roll over government debt. As of late, one should add the fact that the Fund and other multilaterals have been totally unwilling to support fixed exchange rate regimes recently, adding an additional source of instability for countries that follow a pegged exchange rate regime.

As a result, the past several years have seen a spate of both large and small sovereign bond exchange operations, many of them of “distressed” debt. What is remarkable about these bond operations is that there has been no formal mechanism for resolving debt problems. Moreover, the approach has varied from case-to-case. The overall situation can best be described as one of muddling through.

Until fairly recently, the popular view was that sovereign bond exchanges were extremely difficult to undertake. There are several reasons behind the perceived difficulty of such bond operations. First, is an increasingly large number of diverse and anonymous investors that hold bonds. The diverse goals of private bondholders and their large numbers pose difficulties of coordination (compare this to a handful of creditor banks under the loan restructurings of the 1980s). Second, is the legal recourse available to bondholders, which can disrupt bond restructuring negotiations as hold-out investors seek repayment through national courts.³⁸ Indeed, the threat of such a disruption may actually deter a country from seeking a necessary restructuring.³⁹

Recent sovereign bond exchanges like those of Pakistan, Ukraine, Ecuador, Argentina (June 2001), and Uruguay (May 2003) demonstrated that bond exchange operations may be relatively easy to implement and can be completed in a short period.⁴⁰ The experience from these bond exchanges also suggests that high investor participation

³⁸ Holdout creditors are those creditors who are unwilling to accept a bond restructuring by the sovereign. These creditors are usually small in number, but can exhibit opportunistic behavior that can derail a bond restructuring.

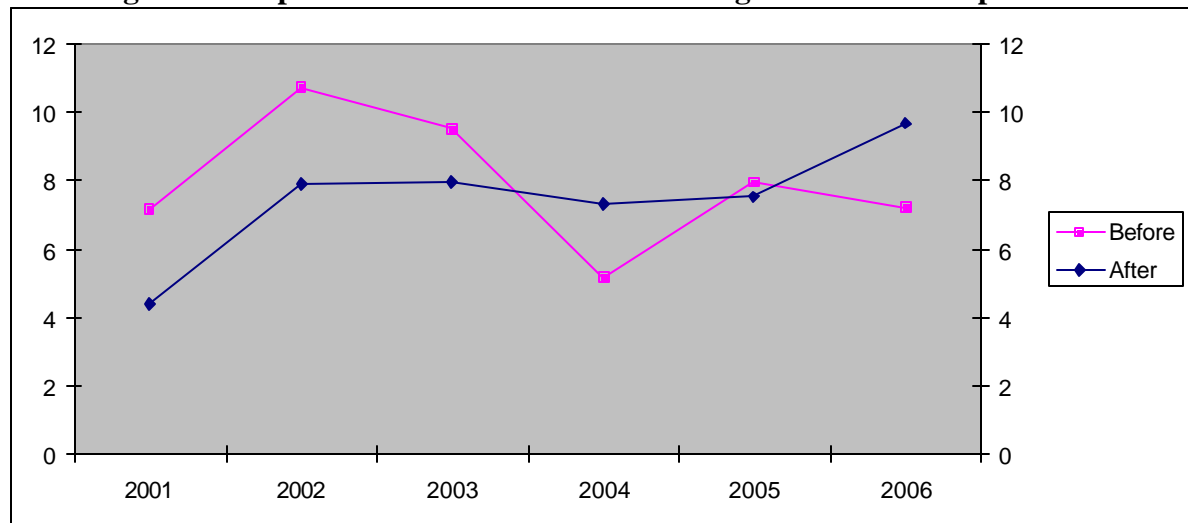
³⁹ See Krueger (2001, 2002).

⁴⁰ See Chuhan (2001).

may be achieved without the use of collective action clauses.⁴¹ Moreover, the fears that litigation would disrupt some of these bond operations were not realized. With about \$500 billion in emerging market bonds, and nearly \$400 billion in public and publicly guaranteed bonds, the recent bond exchanges are significant as they provide a precedent for future sovereign bond exchanges of distressed debt.

A bond exchange operation can be voluntary or involuntary (concerted). Voluntary exchanges involve debt that is being serviced, although default could occur. In a voluntary operation, the market price of the exchange is expected to be higher than the pre-exchange price, with the investor likely to get all the benefit of the price increase. Voluntary exchanges are also likely to include sweeteners in terms of higher interest rates and more liquid or tradable bonds to attract investor participation. The benefit to the debtor is to achieve a re-profiling of its debt service, so as to reduce rollover risk in the near and medium-term. For example, Argentina's "mega" bond exchange lowered debt service payments in 2001-03 (Figure 2). Uruguay's bond exchange re-profiled lower maturities yielding a nominal saving of \$0.45 billion in amortization in 2003 and \$2.4 billion between 2003-10 (Figure 3).⁴² ⁴³ Voluntary exchanges typically do not lower the value of debt relative to its face value, but may include a reduction in NPV in some cases. Involuntary exchanges involve defaulted debt. Such exchanges will likely involve a haircut for investors and a subsequent debt reduction for the debtor. (A default may also have costs like loss of reputation and market access, as well as domestic output losses for the debtor.) Thus, the present value of the debt after the exchange is likely to be less than the face value of the defaulted debt.

Figure 2
Argentina: Impact of the June 2001 bond exchange on debt service profile

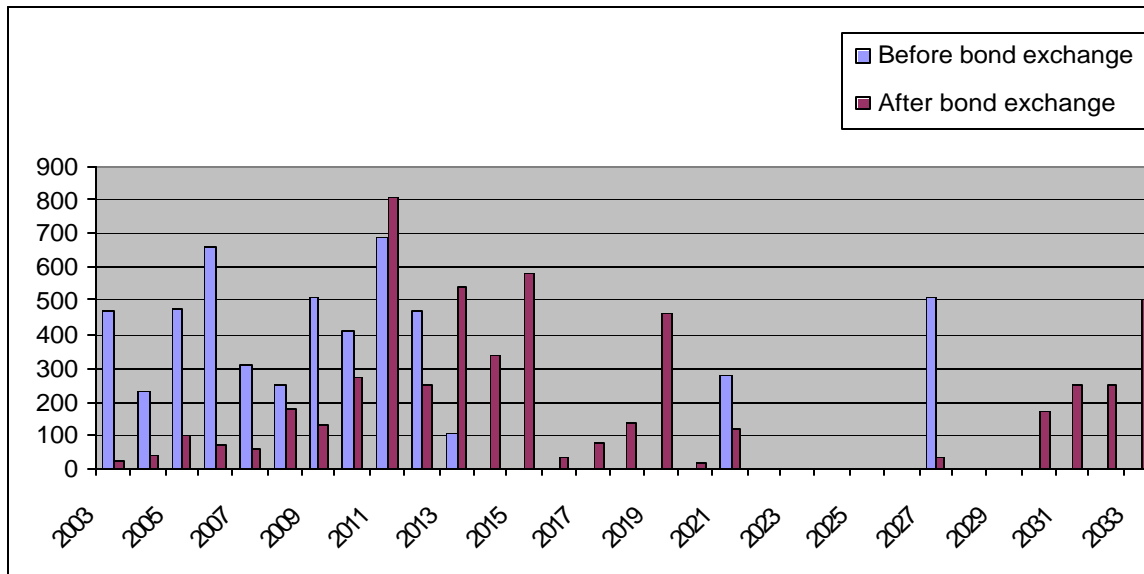


⁴¹ Inclusion of collective action clauses or CACs in bond contracts are viewed as being potentially helpful in bond restructurings, because they allow for collective representation of bondholders and for qualified majority voting to change payment terms on bonds. Cram down clauses force holdout investors to join the majority of investors. Also see Annex 2.

⁴² Domestic bonds account for a larger share of the reduction in amortization in 2003-04, while international bonds dominate the savings in amortization during 2005-10.

⁴³ A novel feature of the Uruguayan restructuring has been the use of collective action clauses in its Samurai bond to avoid holdouts, and the issue of new bonds with collective action clauses.

Figure 3
Uruguay: Impact of the May 2003 bond exchange on maturity profile



* Includes both international and domestic bonds.

A recent example of a voluntary bond exchange of “distressed” debt was Pakistan in late 1999 (Annex 3). Argentina’s mega bond exchange of June 2001 was viewed by the market as a voluntary exchange during a period of heightened credit risk for the country.⁴⁴ Uruguay’s bond exchange was also undertaken in the face of financing difficulties. The amount of bonds exchanged by Pakistan totaled \$0.6 billion, while the Argentine mega bond exchange involved \$29.5 billion. Both these countries provided some form of sweetener to enhance investor participation. For example, the terms offered by Pakistan on the new bond provided a sweetener relative to the prevailing market price of the bond, and the size and structure of the new bond implied that this instrument would be more liquid than the original bonds. These factors, along with a relatively narrow and small investor base - mostly institutional investors – yielded a high investor participation rate - near 99%. The high investor participation rate meant that collective action clauses did not need to be invoked in the Pakistan bond exchange. The new bonds issued under Argentina’s bond exchange operation had a higher average yield than the old bonds, and because of their size were potentially more liquid than the old bonds. By extending maturities without affecting nominal debt stocks, Uruguay’s \$5.1 billion bond exchange achieved some reduction in debt in present value terms. However, the exchange did provide \$107 million in up-front cash payments of principal and interest.

⁴⁴ See IMF (2001).

Table 4

EXTERNAL BOND EXCHANGES						
	Voluntary Approach			Concerted Approach		
	Argentina* Jun-01	Pakistan Nov-99	Uruguay** May-03	Ukraine Feb-00	Ecuador Aug-00	Russia Aug-00
Debt Eligible	\$29.5 billion	\$0.61 billion	\$5.4 billion	\$2.7 billion	\$6.7 billion	\$31.8 billion
Debt Reduction	No debt reduction	No debt reduction	No debt reduction	No debt reduction	Average of 40%	Average of 36.5%
Amounts Exchanged	\$29.5 billion	\$0.61 billion	\$5.1 billion	\$2.3 billion	\$6.6 billion	\$31.8 billion
Exchange Bonds Issued	\$30.4 billion	\$0.62 billion	\$5.1 billion	\$2.3 billion	\$3.95 billion	\$21.14 billion
	5-year local bond 7-year, 17-year, and 30-year global bonds	5-year eurobond	Benchmark bonds: 8-year, 12-year, 30-year Extension bonds: 5 to 14 years	7-year eurobond in US\$ and Euro	30-year and 12-year eurobonds	30-year and 10-year eurobonds

* Exchange includes \$2.1 billion of local bonds eligible for exchange.

** Includes \$1.6 billion of foreign-currency denominated domestic bonds eligible for exchange.

Two recent examples of involuntary bond exchanges were the bond restructurings by Ecuador and Russia (notes for bonds).⁴⁵ Both these bond operations involved debt reduction, and the amounts of bonds exchanged were \$38.4 billion, with Russia accounting for \$31.8 billion. Ecuador's bond exchange operation involving defaulted Brady bonds and eurobonds, resulted in a 41% (overall) reduction in principal for bondholders. Investor participation in the deal was about 97%, well over the 85% acceptance level. One factor that encouraged participation was the government's offer to pay bondholders \$140 million of past-due principal and interest on defaulted bonds. Exit amendments to cross default and negative pledge clauses in the old bonds, by investors who were tendering their old bonds for new bonds, and an amendment to de-list the bonds, pushed up the investor participation rate as well.⁴⁶ Ecuador's bond restructuring (from default to bond exchange) was completed in about one year: a relatively short time period compared to the loan restructuring episodes of the 1980s. Although Ecuador's bond exchange offer involved a haircut for creditors, the country did not engage in formal negotiation with its bondholders. A Consultative Group comprising large institutional investors was set up, but the function of this group was to provide a medium for communication between the government and the creditor community and not to negotiate the terms of the offer.

Russia's debt operation exchanged Vnesheconombank's \$31.8 billion of Prins and IANs for \$21 billion of new instruments - Eurobonds of the Russian Federation due in 2010 and 2030. The restructuring carried a substantial principal reduction: 37.5% for

⁴⁵ Argentina defaulted on its debt in 2002 and this default has not been resolved yet.

⁴⁶ Lee C. Buchheit and G. Mitu Gulati, 2000, "Exit Consents in Sovereign Bond Exchanges," UCLA Law Review, Vol. 48, Number 1.

Prins and 33% for IANs (Figure 4). The deal had many interesting features. Among these:⁴⁷

- a) There was an *upgrade in the obligor*, as creditors had had relatively limited legal recourse after the December 1998 default on the Prins and IANs, because Russia did not guarantee the debt incurred by Vnesheconombank. Now it assumed that debt directly.
- b) *Expanded Cross Acceleration Clauses* by which the country committed to include in any new issues clauses to ensure equal status in the event of default or acceleration of the 2010 and 2030s. The clauses would be symmetric, tying default on the 2010 and 2030 to new issues of sovereign Eurobonds.
- c) In order to have these bonds rank *pari-passu* with other Eurobonds, holders of existing and other new issues of the Russian Federation would *have the right to put back* to Russia at par those bonds, in the event of acceleration of the 2010 and 2030. This repurchase right would expire once Russia issued at least 1 billion of new Eurobonds, as Russia committed to include expanded cross acceleration clauses tied to 2010 and 2030 in new issues.
- d) MinFins as domestic debt remained subordinated.
- e) Initially, a minimum threshold of 75% of bondholders was needed to consummate the exchange if less than 19 billion was tendered. However, if this happened and Russia wanted to go ahead with the exchange, it had the option open upon requesting consent from creditors to do so.
- f) Russia retained the right to re-tap both the 2010s and 2030s without prior notice. This was included to allow for additional restructuring of FTO paper, and did not work against the deal.⁴⁸

Ukraine's bond operation in early 2000 could be viewed as a concerted bond exchange as the country was not current on its bond payments. Ukraine provided a \$220 million pay-out of accrued interest and also used collective action clauses in three of its bonds to boost investor participation.

The experience from the six bond exchanges discussed above suggests that these operations may be relatively easy to implement and can be completed in a short period, despite the lack of a formal mechanism for bond workouts. These bond exchanges were also successful in achieving high investor participation without the use of collective action clauses. These bond workouts demonstrate that markets appear to be responding fairly well to the financial structures in which they are operating, and that creditor coordination issues have not undermined the debt resolution process.

The description leaves out the recent case of Argentina, where a resolution to the debt crisis is still in process. Almost two years into the Argentine default, and with many uncertainties to be resolved, a couple of distinctive features are already clear. First, that

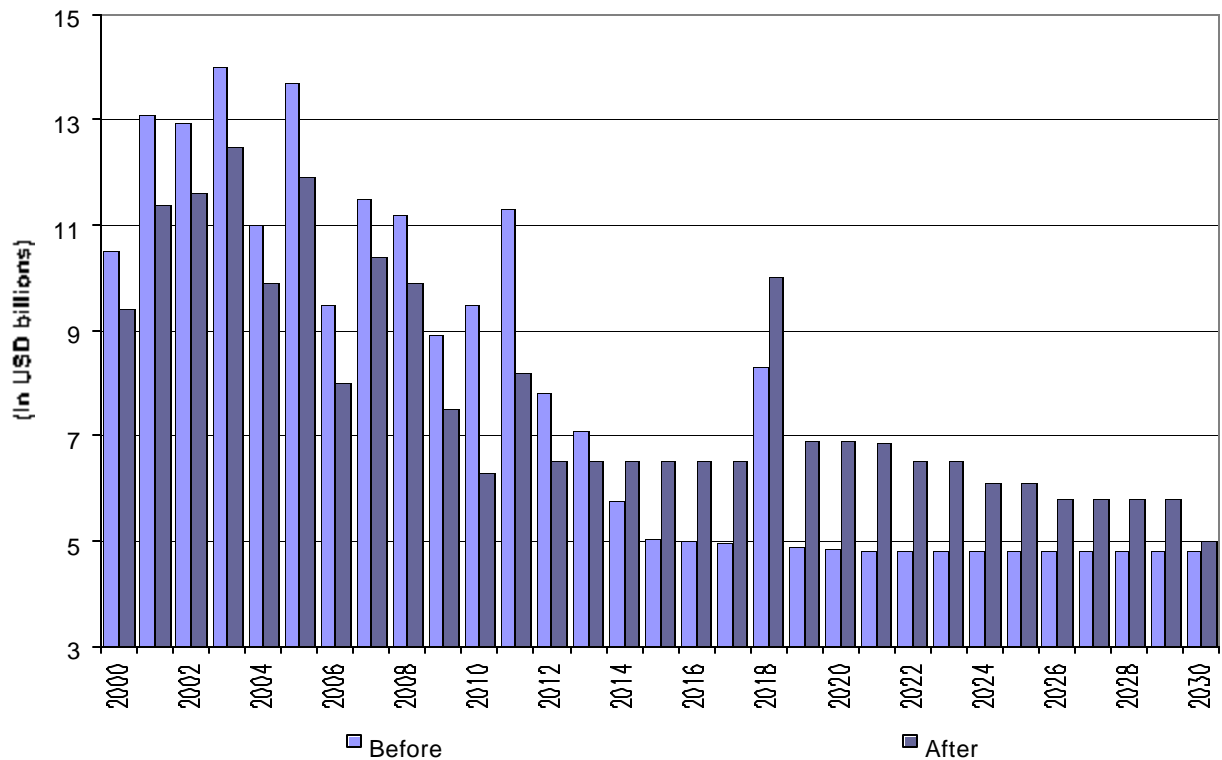
⁴⁷ See JP Morgan (1997 and 2000).

⁴⁸ FTO paper corresponds to unsecured and uninsured foreign exchange assets of Foreign Trading Organizations had as FX denominated deposits at Vnesheconombank and hence originally London Club eligible.

this will be a longer and less friendly restructuring when compared to other bond workouts since 1998. Second, that the haircut will be much larger than that of any of the recent debt workouts. Third, that the power of litigation is extremely minor. So far the few cases brought to Judge Griesa in the New York courts, have faced a clear resistance to impose attachments that may derail the restructuring process. More so, plaintiffs had difficulties in specifying to the judge potentially attachable assets.⁴⁹ As of writing bond holders had offered the government maturity extensions and substantial interest rate reduction delivering an estimated NPV reduction of about 60%. At the time the government was offering an NPV reduction of about 92%. As the economy recovers it is likely that the final agreement will imply a larger return to the shareholders, however the haircut will be larger than that of any recent restructurings.

⁴⁹ German courts have been more belligerent and have attached diplomatic employees payments. The Argentine government moved such payment to Switzerland.

Figure 4
Russia: Impact of the August 2000 bond restructuring on debt service



Some complexities regarding bond defaults. In contrast with the mechanics of the 1980s, in which a sudden halt in financing prompted a default, the experiences in the late 1990s left open many more dimensions on which the country had to make decisions. First of all, countries had to decide which instruments they would default upon and or exchange in turn which broad group of creditors would be affected. The countries also had to decide if the default would be focused on local creditors or on foreign creditors. In some cases this distinction is difficult to make, but some instruments are clearly segmented in terms of their bearers, so that, to some extent, segmentation is at least partially feasible. While in general, policy-makers would prefer to go harder on foreign creditors, the reputation and international implications of such decision may make this alternative unfeasible. Thus, one thing is what policy-makers would prefer to do, and another is what they may be able to.⁵⁰

⁵⁰ Similarly, a decision has to be made regarding debts with IFIs and bilateral lending. Here there appears to be a clear pattern. IFIs lending is seen as senior to everything else, with only few cases of default with multilaterals. This seniority may be a way of buying the seal of approval that only IFIs can provide to a country, as well as the direct link that multilaterals open with the countries that own these organizations. In many cases, it is the private creditors themselves that want the country to agree with the multilaterals first, as they consider that their job is to go through a “due

For example, Ecuador and Argentina (2002) chose to default on all debt instruments. By contrast, Russia, Ukraine and Uruguay chose a limited default or exchange that covered just a few type of instruments. When Ecuador decided initially to exclude Eurobonds from its default, it met criticism from the international financial community, which requested a sort of pari-passu clause among bondholders that obliged the Ecuadorian government to backtrack this decision and include Eurobonds in the restructuring deal. However, it did manage to limit the discount on PDI bonds, which were mostly held by local bondholders. On the other hand, Russia initially defaulted mostly on local bondholders (holder of GKO and OFZs).⁵¹ Argentina, implemented a local-exchange in November 2001 in anticipation of a harsher restructuring of external debt.⁵²

Similarly, governments had to decide whether to do the default in several successive steps or as a one shot move. The initial defaults (Russia and Ukraine) were of the stepwise nature, with the country denying default to the last minute, only to restrict the default to specific instruments and those strictly necessary. The most recent two, Ecuador and Argentina, were broader and simultaneous. To a great extent how the default is implemented is closely related to the motives of default. A country facing a liquidity or credibility problem may choose to default selectively, to obtain the necessary relief to go through a particularly difficult moment in terms of financing needs. Countries with a solvency problem or with unwillingness to pay may be more inclined to broad-based default.

IV. Lessons for the future

Does the debt default experience of the 1990s have applicability in a forward-looking sense? The basic issue is whether there is a case for a formal international mechanism for debt workouts or are markets addressing these issues adequately. The current approach to resolving debt crisis is informal and has a precedent in recent bond operations. While it represents a market-based approach, it is clearly one of muddling

diligence” process with the country, which they cannot do themselves. Thus, the seniority of IFIs lending is a market accepted and encouraged outcome. On the other hand, bilateral lending and concessional official lending is usually considered junior to other lending. For example, Pakistan built substantial arrears with the Paris Club, while never entering in default with private bondholders. Ecuador was in arrears with the Paris Club and still was able to issue a Eurobond in 1997.

⁵¹ However, there were sizable holdings of these instruments by non-residents.

⁵² This debt was later pesified. As many local pension funds did not accept this pesification and sued the government, in response the authorities moved them back to the pool of defaulted debt. Furthermore, the government barred the possibility of switching their debt to indexed pesos, an alternative that should have been attractive both to government and pension funds. Later on, as a result of a popular outcry the government allowed for this swap in the current restructuring proposal, where it is expected local pension funds will obtain a better deal.

through. Better debt workout mechanisms might be possible, namely mechanisms that would correct for (or reduce the inefficiency from) perceived collective action failures on the creditor side. These include market-based approaches like the inclusion of collective action clauses in new bond contracts, establishment of formal bondholder councils, and more comprehensive and sweeping approaches like an international bankruptcy procedure like the IMF's Sovereign Debt Restructuring Mechanism (SDRM).

Following the Mexican Tesobono crisis of 1994-95, Sachs (1995) emphasized the need for new institutional arrangements to deal with debt crises resulting from investor overreaction and debt runs. He advocated an international bankruptcy mechanism to counter this type of market inefficiency and to achieve orderly debt workouts. Such a procedure would call for a payment standstill by the debtor country during debt renegotiations. While the international bankruptcy mechanism advocated by Sachs would streamline debt workouts, it would not address the important issue of moral hazard for debtors.

The SDRM is part of the IMF's effort to improve crisis management and the international financial architecture.⁵³ The SDRM addresses the problems of creditor coordination in debt workouts by proposing a statutory approach that borrows some of the principles of U.S. domestic corporate bankruptcy and collective action clauses.⁵⁴ The key elements of the international bankruptcy procedure are: provision allowing an insolvent country to activate the SDRM on request; aggregation of all external debt owed to private creditors; provision allowing a supermajority of creditors to negotiate a debt restructuring that would be binding for all creditors; sharing of proceeds from litigation; and provision permitting disputes to be adjudicated by independent bankruptcy tribunals. Thus the SDRM would make it easier for a country to reach an agreement with a supermajority of its creditors, while avoiding a creditor holdout problem.

By providing a predictable environment for restructuring, the SDRM would facilitate an orderly debt workout and avoid prolonged and costly debt renegotiations. Reducing transactions costs in this way, enhances efficiency and stability of the international financial system. The SDRM has some potential disadvantages, however. Notably, it could contribute to the problem of moral hazard for debtors (i.e. it does not eliminate the moral hazard problem). By lowering the costs of crises, debtors might be more likely to over borrow and ignore fiscal discipline. And, if it does not stimulate moral hazard problems, it will be unable to avoid excessive delays in debt resolution as countries struggle to avoid falling into an SDRM restructuring process. Implementation issues also complicate the viability of the SDRM: the SDRM calls for changing IMF Articles to override some aspects of domestic law, and these changes may not survive legal challenges.

An intermediate proposal, that could be characterized as an intermediate approach between the contractual (CACs) and statutory approaches (SDRM) is what is known as

⁵³ See Boorman (2002), Krueger (2001, 2002) and Rogoff and Zettelmeyer (2001).

⁵⁴ There is some similarity with corporate debt reorganization under Chapter 11 of the United States Bankruptcy Code.

the Trichet proposal⁵⁵, which calls the compliance with a Code of Good Conduct (CGC). CGC defines nine principles that should be agreed by both creditors and debtors: early engagement with creditors before and after debt servicing problems arise, fair information sharing, fair representation of creditors, an expeditious and cooperative process, comparable treatment among creditors, fair burden sharing, good faith negotiation, preserving of debtor's financial situation, and a quick restoration of debt sustainability. The weakness of the proposal relies on the fact that, while everybody may agree ex-ante to comply with these principles, the power to enforcement them once a default has occurred, appear rather limited.⁵⁶

In moving forward on approaches to debt restructuring, there appears to be broad support in the international community for incremental change-type solutions as opposed to solutions that radically overhaul the international financial architecture. Thus, voluntary, market-friendly approaches to debt restructuring - such as the inclusion of CACs in sovereign bond contracts - are increasingly being viewed as a step forward in improving the current debt restructuring process. This, despite the concern that CACs would likely impose higher borrowing costs and lower overall financial flows to emerging markets. By facilitating coordination among creditors and lowering the cost of restructuring, CACs could contribute to a moral hazard problem for debtors.⁵⁷

Eichengreen and Portes (1995) first introduced the concept of using contractual innovations such as collective action clauses so as to overcome creditors' collective action problems. They argued against a statutory approach, on the grounds that it would be difficult to implement and, more importantly, because of the moral hazard problem for debtors that such an approach would create. They also see some merit in having an informal bondholders' organization that would function like the London Club.

Using a model of sovereign debt, Kletzer (2003) argues that CACs are more efficient than the commonly used unanimity clauses in bond contracts, because unanimity clauses can promote rent-seeking behavior in creditors and this can give rise to inefficient outcomes for lending and repayment.⁵⁸ He further concludes that if all sovereign bonds have CACs, then there is no added benefit of establishing a formal international bankruptcy procedure (i.e. the SDRM). However, renegotiation costs may invalidate the welfare equivalence of CACs and the SDRM-type statutory approach. Thus, if the formation of bondholder renegotiation committees is costly because of a large number of different bonds issued in different legal jurisdictions, then the SDRM might be more efficient because it aggregates debt. Also, while the CAC approach is useful in a

⁵⁵ See Trichet (2001) and Couillault and Weber (2003).

⁵⁶ Argentina, however, has claimed its willingness to comply with this code of conduct. Whether this is just cheap talk is also still an open question.

⁵⁷ Eichengreen and Mody (2000) find that for creditworthy borrowers the inclusion of CACs lowers bond spreads in primary issues, but less creditworthy borrowers are likely to experience higher spreads on bond issues.

⁵⁸ Kletzer obtains these results by making the assumption that the transaction costs of renegotiations are either zero or lower under contracts with CACs than those with unanimity clauses.

forwarding looking sense, it does not effectively address the issue of default on existing bonds (the so-called transition problem), most of which do not have CACs.

Collective action clauses have begun appearing in several recent sovereign bond issues. For example, this February, Mexico became the first major emerging market borrower to issue a bond with CACs under New York law, and Uruguay issued all of its bonds created during the recent bond restructuring with CACs, also under New York law. Although these developments suggest a growing market support for the CAC approach, it is too early to tell whether the inclusion of CACs in bond contracts will become widespread. Again, while CACs address the creditor coordination problem for individual bond issues, they do not solve the problem of cross-issue creditor coordination -- the so-called aggregation problem -- or the problem of creditor coordination for the existing stock of debt (the so-called transition problem).

Thus, there is a recognition that CACs may not go far enough to smoothing the debt restructuring process, and that additional mechanisms will be needed. Eichengreen, Kletzer, and Mody (2003) suggest that super-collective action clauses, bondholder committees, and code of creditor conduct might be such additional mechanisms. For example, super-collective action clauses in bond contracts would overcome the cross-issue coordination problem by allowing a qualified majority of bondholders to vote on bond restructuring terms. By facilitating creditor coordination, bondholder committees would likewise enhance the debt workout process. However, bondholder committees may provide only limited benefits because they would not overcome the problem of lawsuits from holdout creditors.⁵⁹ The debate on the usefulness of these and other additional mechanisms is evolving, and there is no consensus yet on the next set of innovations that will be needed to improve debt crises resolution.

As we move ahead in the Argentine restructuring, some lessons are clear. On the one hand, that bond restructurings are feasible, and can be implemented relatively quickly, even if they entail large haircuts. On the other hand, however, it is true that such debt restructurings are extremely costly to both creditors and debtors. Finally, that these restructurings are far from providing even a minimum of intercreditor equity. In the Argentine case, while IFIs are being paid in full, other bondholders have not been defaulted and other have received an offer for a 92% haircut. As mentioned above such traumatic events may be necessary for sovereign debt to exist, but to the extent that such large crises impose deadweight costs, and *do occur* (as opposed to being some off equilibrium outcome used for deterrence), it is likely that there is still much to be improved upon, as market players, IFIs and creditor countries continue struggling in the common objective of building a smoother and safer global capital market.

⁵⁹ Mauro and Yafeh (2003).

Collective action clauses approach

What is it

Changing majority action clauses in debt instruments.

Features

CACs apply to individual bond issues.

A supermajority of bond holders (usually 75%) can agree to changing payment terms of the bond and the new terms would be binding for all holders of the bond.

Objective

To facilitate negotiations between debtors and creditors so as to improve the debt restructuring process. Address the problem of coordination among bondholders.

Drawbacks

Inclusion of CACs in bond agreements could raise borrowing costs for this class of instruments.

CACs do not facilitate cross-issue creditor coordination (the aggregation problem).

Existing debt not affected by this (the transition problem), as it would affect new issues only.

Annex 1

Sovereign Defaults on Debt to Private Creditors

(adapted from *Sovereign Defaults: Moving Higher Again in 2003*, Standard and Poor's dated Sept 2002)

RATED ISSUERS: YEARS IN DEFAULT, 1975 - 2002			
ISSUER	LOCAL CURRENCY DEBT	FOREIGN CURRENCY BOND DEBT	FOREIGN CURRENCY BANK DEBT
KUWAIT	1990-91		
SLOVENIA			1992-96
CHILE			1983-90
POLAND			1981-94
MEXICO			1982-90
SOUTH AFRICA			1985-87,89,93
CROATIA	1993-96		1992-96
TRINIDAD & TOBAGO			1988-89
PHILIPPINES			1983-92
EGYPT			1984
EL SALVADOR	1981-96		
MOROCCO			1983,86-90
COSTA RICA		1984-85	1981-90
GUATEMALA		1989	1986
PANAMA		1987-94	1983-96
JORDAN			1989-93
PERU			1976,78,80,83-97
BULGARIA			1990-94
VIETNAM	1975		1985-98
DOMINICAN REPUBLIC	1981-2001		1982-94
RUSSIA	1998-99	1998-200	1991-97
BOLIVIA		1989-97	1980-84,86-93
BRAZIL	1986-87,90		1983-94
ROMANIA			1981-83,86
JAMAICA			1978-79,81-85,87-93
SENEGAL			1981-85,90,92-96
PARAGUAY			1986-92
COOK ISLANDS			1995-98
MONGOLIA	1997-2000		
UKRAINE	1998-2000		1998-2000
URUGUAY			1983-85,87,90-91
VENEZUELA	1995-97,98	1995-97	1983-88,90
PAKISTAN		1999	1998-99
TURKEY			1978-79,82
INDONESIA			1998-99,2000,02
ECUADOR	1999	1999-2000	1982-95
ARGENTINA	1982,1989-90,2002	1989,2001-02	1982-93

Continued

Sovereign Defaults on Debt to Private Creditors

(adapted from *Sovereign Defaults: Moving Higher Again in 2003*, Standard and Poor's dated Sept 2002)

UNRATED ISSUERS: YEARS IN DEFAULT, 1975-2002			
ISSUER	LOCAL CURRENCY DEBT	FOREIGN CURRENCY BOND DEBT	FOREIGN CURRENCY BANK DEBT
ALBANIA			1991-95
ALGERIA			1991-96
ANGOLA	1992-2002		1985-2002
ANTIGUA & BARBUDA			1996-2002
BOSNIA & HERZEGOVINA			1992-97
BURKINA FASO			1983-96
CAMEROON			1985-2002
CAPE VERDE			1981-96
CENTRAL AFRICAN REPUBLIC			1981,83-2002
CONGO (BRAZZAVILLE)			1983-2002
CONGO (KINSHASA)			1976-2002
CUBA			1982-2002
ETHIOPIA			1991-99
GABON			1986-94,99,2002
GAMBIA			1986-90
GHANA	1979		1987
GUINEA			1986-88,91-98
GUINEA-BISSAU			1983-96
GUYANA			1976,82-99
HAITI			1982-94
HONDURAS			1981-2002
IRAN			1978-95
IRAQ			1987-2002
IVORY COST		2000-02	1983-98
KENYA			1994-2002
NORTH KOREA			1975-2002
LIBERIA			1987-2002
MACEDONIA			1992-97
MADAGASCAR	2002		1981-84,86-2002
MALAWI			1982,88
MAURITANIA			1992-96
MOLDOVA		1998, 2002	
MOZAMBIQUE			1983-92
MYANMAR (BURMA)	1984		1998-2002
NAURU			2002
NICARAGUA			1979-2002
NIGER			1983-91
NIGERIA		1986-88,92	1982-92
SAO TOME & PRINCIPE			1987-94
SERBIA & MONTENEGRO			1992-2002
SEYCHELLES			2000-02
SIERRA LEONE	1997-98		1983-84,86-95
SOLOMON ISLANDS	1995-2002		
SRI LANKA	1996		
SUDAN			1979-2002
TANZANIA			1984-2002
TOGO			1979-80,82-84,88,91-97
UGANDA			1980-93
YEMEN			1985-2001
FORMER YUGOSLAVIA		1992-2002	1983-91
ZAMBIA			1983-94
ZIMBABWE		1975-80*	2000-02

*Bonds initially defaulted in 1965. Debt initially defaulted on in 1974.

Annex 2⁶⁰

Collective action clauses include three types of clauses: the sharing clause, the collective representation clause, and the majority clause.

Sharing clause. The sharing clause states that any payments received by one bondholder have to be shared with other bondholders. Sharing clauses were introduced as part of syndicated loans restructuring deals of the 1980s, to protect banks with little relation with a given debtor country that feared that they could be defaulted upon if the debtor prioritized staying current with those banks with which it had stronger commercial ties. In addition, sharing clauses are an important deterrent to litigation, as any proceeds obtained from litigation have to be shared with other bondholders.⁶¹ There are two ways in which the sharing clause can be effected. The English style sharing clause in which the excess payment is handed to a Fiscal Agent for ratable distribution, and the American Style clause in which the original recipient purchases sub participations in other creditor's debt.⁶²

Majority action clauses. While New York law does not allow for changes in the payment conditions without the consent of all bondholders, London Law allows changes in payment terms with a quorum of 75%.⁶³ The rules that allow the change in the terms of the bonds with a qualified majority are dubbed majority action clauses. In the case of Ukraine, the tendering of the bonds in the exchange was automatically a proxy vote to

⁶⁰ This annex draws on Sturzenegger (2002b).

⁶¹ Buchheit (1998b) proposes a sharing clause to read as “Each Bondholder agrees that if it shall obtain (whether by way of payment from the Issuer or following the exercise of set-off rights, litigation or otherwise) any payment in respect of the Bonds held by the Bondholder that is proportionally greater than the payment received by any other Bondholder in respect of the Bonds held by that other Bondholder, then: (i) the Bondholder receiving such excess amount shall pay such excess amount to the Fiscal Agent; (ii) the Fiscal Agent shall treat such amount as if it were a payment received from the Issuer in respect of the Bonds and shall distribute it accordingly; and (iii) as between the Issuer and the Bondholder originally receiving the excess amount, such excess amount shall be treated as not having been paid; provided, however, that no Bondholder shall be required by this Section to share any amount recovered by it as a result of litigation against the Issuer if Bondholder holding at least ..% of the outstanding amount of the Bonds shall have previously consented in writing to the commencement of that litigation.”

⁶² See Buchheit (1998b).

⁶³ Buchheit (1998a) proposes a majority action clause the writing “Modifications and amendment to the Fiscal Agency Agreement or the Bonds requiring Bondholder consent of the issuer and the holder of at least a majority of aggregate principal amount of the Bonds at the time outstanding, provided that no such modification, amendment or waiver of the Fiscal Agency Agreement or any Bond may, without the consent of holders of at least ..% of aggregate outstanding principal amount of the Bonds voting at the bondholders meeting convened for this purpose (i) change the stated maturity of the principal of or interest on any such Bond; (ii) reduce the principal of or interest on any such Bond; (iii) change the currency of payment of the principal of or interest on any such Bond; or (iv) reduce the above stated percentage of aggregate principal amounts of Bonds outstanding or reduce the quorum requirements or the percentage of voters required for the taking of any action.”

apply the majority action clause, thus any bondholder who remained with the original bond risked his terms being changed in such a way that would render the paper less worthy in both characteristics and payment conditions. As the threshold participation rates assigned for the transaction were larger than those required to change the conditions of the bonds, bondholders had a large incentive to participate in the transaction. This type of clauses can be complemented with cram-down clauses. Cram-down clauses force an agreement reached with a majority of bondholders to be binding on holdouts. For example, to protect sovereign debtors from disruptive lawsuits, majority action clauses prevent a small number of creditors from blocking an attempt to renegotiate the terms of the bonds. This clause make litigation feasible only if a majority of bondholders vote in favor of pursuing litigation.

Collective Representation Clauses. Once a country decides to default it needs to establish a counterpart. The experience in recent debt restructurings has been varied. Pakistan established direct contact with major bondholders in order to gauge possible acceptable settlements. Russia negotiated with the London Club. Ecuador on the other hand, called for a creditors committee as a consulting group (this turned ineffectual, as creditors chose to present their demands in a private manner). Legally, the question is whether a debt renegotiation counterpart can be established in the legal framework. One possible candidate to take up such role is the Fiscal Agents under which the bonds were originally issued. This would probably meet with strong resistance both from those Fiscal Agents, which would find themselves involved in a problem between third parties, and by bondholders that could have doubts as to whether the Fiscal Agent would necessarily defend their interests in such renegotiation. Lead managers of the outstanding bonds would be another candidate. But they will probably be equally ill inclined to participate from reluctance to accept any co-responsibility in the default. Finally, a third option is a group of bondholders. As long as this group is not enshrined in the covenants of the Bond, there is no formal obligation to do the negotiations through such group. However, even in those cases, these groups have remained an informal and valid counterpart. Their non binding recommendations, are usually useful to individual bondholders to decide whether to follow suit or not.⁶⁴

In some cases, the debt renegotiation cannot appeal to the majority clause, for example, for bonds issued under New York law. A way around this is known as exit consents that consist of changing the conditions of other characteristics of the bond, in particular non-payment conditions, which can be changed by a qualified majority even under New York law. This methodology was used in the Ecuador restructuring. As bondholders exited from the original instruments they voted for changes in other conditions on the original Brady bonds. Among these, they removed provisions that would have interfered with Ecuador's ability to close the exchange offer at a time when the country was in payment default, they removed the so called exit covenants by which Ecuador had promised never to seek a further restructuring of the Brady bonds, they deleted the cross default clauses, the requirement that all payment defaults may be cured as a condition to any rescission of acceleration, the negative pledge covenant, and the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock

⁶⁴ See Buchheit (1998c).

Exchange.

Annex 3.
Argentine Government Bond Exchange of June 2001

Between June 1-4, 2001 Argentina conducted a “mega” bond exchange operation to extend bond maturities. The government received exchange offers worth \$33.3 billion from bondholders, and swapped existing bonds with an original value of \$29.5 billion for \$31.04 billion of new instruments. The bond exchange was voluntary and was the biggest exchange of its kind.

Under the bond exchange, existing bonds, including Bradys, Eurobonds and local securities, were exchanged for 5 types of new instruments. Three of the new bonds have an interest capitalization feature (up to five years of interest capitalization), and the other two bonds have step-up coupon rates. The five new bonds are:

A \$11.5 billion, 7-year global bond with a 7% coupon for the first three years and 15.5% from the fourth year till maturity. Amortization is in six semi-annual equal payments from June 2006 till December 2008.

A \$0.9 billion, 7-year global bond with a 10% coupon for the first three years and 12.4% from the fourth year till maturity. Amortization is the form of a bullet payment in December 2008.

A \$7.5 billion, 17-year global with a 12.25% coupon and interest capitalization of 5 years. Amortization is in five semi-annual equal payments from June 2016 to June 2018.

A \$8.5 billion, 30-year global with a 12% coupon and interest capitalization of five years. Amortization is in the form of a bullet payment in June 2031.

A \$2.1 billion, 5-year local bond at floating interest rates and interest capitalization of two years.

Argentina: Description of Mega Bond Exchange - June 2001						
New Bonds	Pagare 2006	Global \$/US\$ 2008	Global 2008	Global 2018	Global 2031	Total Exchange
Nominal value of new issues	2,060	931	11,716	7,812	8,521	31,040
Maturity Date	Jun-06	Sep-08	Dec-08	Jun-18	Jun-31	
Coupon	BALDAR (local) +150 bp	10% from first to third year, 12% from fourth year to maturity	7% from first to third year, 15.5% from fourth year to maturity	12.25%	12%	
Interest Capitalization	2 years	No	No	5 years	5 years	
Amortization	6 equal semi-annual payments	Bullet	6 equal semi-annual payments	5 equal semi-annual payments	Bullet	
Average Maturity	3.75	7.25	6.3	16	30	
Schedule of Payments	12/19/03 16.66% 6/19/04 16.66% 12/19/04 16.66% 6/19/05 16.66% 12/19/05 16.66% 6/19/06 16.7%	9/19/2008	6/19/06 16.66% 12/19/06 16.66% 6/19/07 16.66% 12/19/07 16.66% 6/19/08 16.66% 12/19/08 16.7%	6/19/16 20% 12/19/16 20% 6/19/17 20% 12/19/17 20% 6/19/18 20%	6/19/2031	
Issue Price	100%	78%	79%	73%	71%	
Old Nominal Value	2,028	1,215	11,093	7,123	8,034	29,493
Old Market Price	2,030	729	8,999	5,467	6,024	23,249
Clearing price	100%	60%	81%	77%	75%	

Source: Adapted from Ministry of Economy website

Annex 3 contd.
Russian Bond restructuring of 1998

On July 18, Russia launched an exchange offer for its defaulted Prins and IANs, former Soviet Union debt assumed by the Vnesheconombank. The exchange was completed on August 25 2000 and involved the swap of US\$22.2 billion Prins and US\$6.8 billion IANs and overdue interest for two new 2030 and 2010 Eurobonds. Interest arrears from December 2 1998 on Prins and from June 2 1999 for IANs until March 31 2000 were covered by the new bonds. Interest on the new bonds would accrue from March 31 2000.

The 10 year bond was offered to cover overdue coupon payments. This bond issue was of \$2.8 million (9.5% of which was paid in cash at the moment of the offer) and was given in exchange of:

- a) US\$368 million on Prins due on December 2 1998 (the amount that should have been paid in cash⁶⁵);
- b) US\$1.337 million on Prins due on June 2 1999 and December 2 1999 (this included the amount that should have been paid in cash plus the part that should have capitalized);
- c) US\$512 million on Prins accrued from December 2 1999 until March 31 2000 (this included the amount that should have been paid in cash plus the part that should have capitalized);
- d) US\$414 million on IANs due on June 2 1999 and December 2 1999 and
- e) US\$158 million on IANs accrued from December 2 1999 until March 31 2000.

The 30 year bond was offered in exchange of Prins and IANs with an important write-off of 37.5% of nominal value on Prins and 33% of nominal value on IANs.

In September 2000 Russia announced that over 99% in aggregate amount of Prins and 98% in aggregate amount of IANs were tendered in its exchange offer.

This exchange implied an upgrade in the obligor, as the responsibility switched from Vnesheconombank to the Russian government.

Russia: Bond Exchange of 2000	
Agreement Date	2000 July
Debt Eligible	(a) \$ 22.2 billion in defaulted Restructured Principal Bonds (Prins) (b) \$ 6.8 billion in defaulted Interest Arrear Notes (IANs)
Discount rate	(c) 37.5% on Prins

⁶⁵ A distinguishing feature of Prins was that a varying portion (ranging from 60% to 15%) of its coupon payments until 2002 capitalized in the form of Ians, the rest of the coupon being paid in cash.

	(d) 33.0% on IANs
Amounts exchanged	\$ 28.6 billion
New Bond Issue	\$ 21.2 billion
2030 Eurobond	In exchange for principal on Prins and IANs
Terms	A sinkable bond repaying its principal in 47 semi-annual installments, since March 31, 2007.
Amounts	\$18.4 billion
Interest rates	Initial coupon rate of 2.25% for the first interest period, rising to 2.5% in the second interest period, 5% from year 2 to year 7 (inclusive) and 7.5% thereafter.
2010 Eurobond	In exchange for overdue interest on Prins and IANs
Terms	9.5% paid in cash on issue date. 9 equal semi-annual amortization payments commencing March 31, 2006.
Amounts	\$2.8 billion
Interest rates	8.25%

Annex 3 contd.
Ecuador Bond Restructuring of 2000

In August 2000, Ecuador completed a bond exchange operation involving defaulted Brady bonds and eurobonds. \$5.9 billion of defaulted Brady bonds and \$465 million of eurobonds were swapped for two global bonds with a face value of \$3.9 billion. The global bonds comprised a \$2.7 billion, 30-year multi-coupon bond and a \$1.25 billion, 12-year fixed rate bond. All bondholders were first offered the 30-year bond, which could (simultaneously) be exchanged for the 12-year bond at an additional 35% discount on the principal of the 30-year bond. Ecuador's bond offer resulted in a 41% reduction in principal for bondholders.

Investor participation in the deal was about 97%, well over the over 85% acceptance level. One factor that encouraged participation was the government's offer to pay bondholders \$140 million of past-due principal and interest on defaulted bonds. Exit amendments to cross default and negative pledge clauses in the old bonds, by investors who were tendering their old bonds for new bonds, and an amendment to de-list the bonds, pushed up the investor participation rate as well. The government's pledge to repurchase at least 3% per year of the 30-years bonds, starting in 2013 and at least 10% of the 12-year bonds beginning in 2006, was also a factor.

Ecuador's bond restructuring (from default to bond exchange) was completed in about one year: a relatively short time period compared to the loan restructuring episodes of the 1980s. Although Ecuador's bond exchange offer involved a haircut for creditors, the country did not engage in formal negotiation with its bondholders. A Consultative Group comprising large institutional investors was set up, but the function of this group was to provide a medium for communication between the government and the creditor community and not to negotiate the terms of the offer.

Ecuador: Bond Exchange of 2000	
Agreement Date	2000 August
Debt eligible	<p>(a) \$5.9 billions in defaulted Brady bonds</p> <ul style="list-style-type: none"> \$1.6 billion of PAR Bonds \$1.4 billion of discount bonds \$2.2 billion of PDIs \$181 million of IEs <p>(b) \$465 million in 5- and 7-year eurobonds</p> <ul style="list-style-type: none"> \$322 million of 11.25 % fixed-rate 2002 eurobond \$143 million of floating-rate 2004 eurobond
Discount rate	41%
Amounts exchanged	\$6.7 billion
New Bond issued	\$3.95 billion
30-year multicoupon bond - first phase	All investors were offered the 30-year bonds, which can be exchanged for the 12-year bonds for an additional 35% discount bullet payment in 2030
Terms	Initial coupon rate of 4% until August 2001, reset annually at 5%, 6%, 7%, 8%, 9%, thereafter 10 %.
interest rates	
12-year bond - second phase	
Terms	bullet payment in 2012
interest rates	12% fixed interest rate
	<p>With the released collateral, the government offered to pay bondholders 140 million of past-due principal and interest in defaulted debt .</p> <p>The government pledged to repurchase at least 3% of the 30-year bond , starting in 2013 and at least 10% of the 12-year bond beginning in 2006</p>
PDIs: Past-due interest bond	
IEs: Interest equalization bond	

Annex 3 contd.
Pakistan Eurobond Exchange of 1999

The January 1999 agreement with Paris Club creditors required Pakistan to obtain comparable treatment of its debt due to all its external public or private creditors, including to bondholders. This meant that the government had to seek from its bondholders a reorganization of its bonds on terms comparable to those on bilateral debt.

On November 15, Pakistan launched a “voluntary” bond exchange involving three dollar-denominated eurobonds with a face value of \$610 million. The three bonds were: a \$150 million, 11.5% eurobond due in December 1999; a \$300 million floating rate note due in May 2000; and a \$160 million, 6% convertible bond due in February 2002 and with a put in February 2000. Under the bond operation, the three eurobonds were swapped for a six-year, \$623 million eurobond with a 10 percent coupon.

The bond operation was viewed as a success because of the very high investor participation rate – near 99%. A relatively narrow investor base – a limited number of mostly institutional investors - and the possibility of a default on the original bonds are believed to have contributed to the high participation rate. Investor participation was also boosted by the terms on the new bond, which provided a sweetener relative to the prevailing market price. The size and structure of the new bond implied that this instrument would be more liquid than the original bonds, thereby, adding to the attractiveness of the offer. Because of these and other factors, majority or collective action clauses in the old bonds did not need to be invoked to achieve high investor participation.

Pakistan Bond Exchange of 1999	
Agreement Date	1999 November
Debt eligible	(a) \$150 million, 11.5 % eurobond due in December 1999 (b) \$300 million floating rate note due in May 2000 (c) \$160 million, 6% convertible due in February 2002
Discount	no debt forgiveness
Amounts exchanged	\$610 million
New bonds	
Eurobond 2005	
Terms	matures 2005
Amounts	\$623 million
interest rates	10%; semi-annual payments in May and November

Annex 3 contd.
Ukraine Bond Exchange of 2000

On February 4, 2000, Ukraine presented an offer to exchange its eurobonds for new bonds. The exchange involved four eurobonds and all Gazprom bonds. The eurobonds comprised a 500 million pound sterling, 14.75% eurobond due March 2000, a \$258 million zero-coupon eurobond due September 2000, a \$75 million, 16.75% eurobond due October 2000, and a DM 1.5 billion, 16% eurobond due February 2001. \$280 million of Gazprom bonds falling due in 2000-01 were included in the exchange, and later on \$735 million of Gazprom bonds maturing between 2002-06 were also added to the offer.

Of the \$2.7 billion of debt eligible under the offer, \$2.3 billion was exchanged for two new bonds: a \$1.13 billion, 7-year eurobond with an 11% coupon and a 1.13 billion euro-denominated, 7-year eurobond with a 10% coupon. The investor participation rate exceeded the minimum 85% participation acceptance level that had been set for eurobonds and bonds falling due in 2000-01. This is noteworthy, because 40% – 50% of the investor base was comprised of retail investors. A sweetener to investors in the form of a \$220 million pay-out of accrued interest helped boost investor participation. The use of collective action clauses in three of the bonds (the DM 1.5 billion bond did not have CACs) may also have exerted a favorable affect on participation.

Ukraine: Bond Exchange of 2000	
Agreement Date	2000 February
Debt eligible	About \$2.7 billion (a) 500 million Sterling Pounds Eurobond due in 2000/03 (b) \$258 million Zero coupon paper due in 2000/09 (c) DM 1.5 billion eurobond due in 2001/02 (d) \$ 75 million eurobond due in 2000/10 (e) \$ 280 million of Gazprom bonds due in 2000 and 2001 (f) \$ 735 million of Gazprom bonds due in 2002-2006
Discount	no debt forgiveness
Amounts exchanged	\$ 2.3 billion
New Bond issued	
7-year Eurobond either	
(a) denominated in Euros	
Terms	semi-annual amortization payments with six-month grace period (schedule)
Amounts	1.13 billion Euro
interest rates	10%
(a) denominated in US\$	
Terms	semi-annual amortization payments with six-month grace period (schedule)
Amounts	\$1.13 billion
interest rates	11%
Notes:	
2000/02 agreement not to be confused with	
(a) 1998/09 \$ 590 million exchange of short-term domestic T-bills held by non-resident for dollar-denominated 2-years eurobond,	
(b) 1999/07 \$163 million Eurobond swap to 3-year D-Mark-denominated eurobond (80%) and 20% cash payment	

Annex 3 contd.
Uruguay Bond Exchange of May 2003

In May 2003 Uruguay conducted a voluntary bond exchange operation to re-profile debt maturities. Under the debt operation, existing bonds, including Bradys, Eurobonds, Samurai bonds, and domestic securities, were exchanged for several types of new instruments. Of the \$5.4 billion of foreign-currency denominated international and domestic securities eligible for the exchange, \$5.1 billion were swapped.

The exchange had an international component and a domestic component. The international exchange offer covered \$3.8 billion of foreign securities, including \$400 million of Brady bonds and \$250 million of Samurai bonds. The holders of the bonds were offered two types of swap options:

A liquidity option - old bonds would be exchanged for new US dollar denominated fixed rate bonds that are expected to be traded in the secondary debt market and that would provide a benchmark for future issues.

A maturity extension option – old bonds would be exchanged for new bonds, generally at par value and at the same coupon rate, for new bonds with deferred maturities. The option maintained the currency and the coupon of issuance. Samurai bonds would be amended so as to extend the maturity from 2006 to 2011, and to raise the interest rate from 2.2% to 2.5%.

The new instruments included collective action clauses, which would allow a supermajority (75 percent) of bondholders to modify bond repayment terms. Also, there was a sweetener - upfront cash payment - for securities maturing in the near to medium term, 2003-07.

The domestic exchange offer covered \$1.6 billion of bills and longer-term instruments. Like the foreign bonds, the new domestic bonds included CACs. In addition, cash incentives were applicable to debt-maturing in the short term, i.e. in 2003.

At 90 percent for the international offer and 98 percent for the domestic offer, the investor participation rate met the target rate of at least 90 percent set by the authorities. Investors appeared to favor the liquidity option: the new benchmark bonds account for 73 percent (or \$2.6 billion) of the new external bonds, while the maturity extension bonds account for 28 percent (or \$0.8 billion).

Uruguay Bond Exchange of 2003

(in million US\$)

Agreement date	2003 May
Debt eligible	5,390
International exchange offer	3,771
of which Brady bonds	401
Samurai bonds	250
Domestic exchange offer	1,619
Amounts exchanged	5,055
International exchange offer	3,455
of which Brady bonds	239
of which Samurai bonds	250
Domestic exchange offer	1,600
Discount	none
Cash payment	107
New external bonds issued	3,426
Benchmark Bonds:	2,614
7.25% bond maturing in 2011 in US \$	500
7.50% bond maturing in 2015 in US\$	1,059
7.875% bond maturing in 2033 in US\$ (PIK)	1,055
Extension Bonds	812
7.875% bond maturing in 2008 in US\$	84
8.375% bond maturing in 2011 in US\$	61
7.0% bond maturing in 2013 in US\$	64
7.25% bond maturing in 2014 in US\$	32
7.875% bond maturing in 2014 in US\$	20
8.75% bond maturing in 2015 in US\$	51
7.625% bond maturing in 2017 in US\$	41
FRN bond maturing in 2009 in US\$	2
FRN bond maturing in 2010 in US\$	5
CLP bond maturing in 2016 in CLP	2
EUR bond 7% maturing in 2012 in EUR	110
EUR bond 7% maturing in 2019 in EUR	139
SAMU bond 2.5% maturing in 2011 in JPY	203

Source: Central Bank of Uruguay.

Annex 4**East Asia crisis and debt workouts**

In the wake of the East Asia crisis of 1997, domestic financial institutions in Korea and Indonesia faced severe payment difficulties on their external debts. These were forced to reschedule their debt obligations with the help of government guarantees.

The Korean rescheduling - In March 1998, the Korean government signed an agreement with foreign creditor banks on rescheduling short-term foreign debt of domestic financial institutions. The agreement scheduled \$24 billion of short-term foreign debt into long-term debt: loans with one to three years maturity and interest rate spreads over Libor of 225 bp for one-year loans, 250 bp for two-year loans, and 275 bp for three-year loans. \$20 billion of the new debt carried government guarantees.

In June 1998 (Frankfurt Agreement), Indonesia reached an agreement with a group of 13 foreign creditor banks on a framework for rescheduling private sector debt (\$80 billion). The categories of debt covered were interbank debt, trade finance and corporate debt. Indonesian commercial banks' were able to exchange their foreign currency obligations to foreign banks for new loans with government guarantees. The new loans ranged in maturity from one to four years, and were at interest rate spreads of 275 bp, 300 bp, 325 bp and 350 bp over Libor. About \$7 billion of the \$9.2 billion of short-term interbank debt was rescheduled. The framework for corporate debt restructuring allowed Indonesian companies to reschedule their loans with a three-year grace period and an eight-year maturity and a real interest rate of 5.5 percent. The creation of the Indonesian Debt Restructuring Agency (INDRA) was to provide foreign exchange cover for Indonesian corporations with foreign currency debt, once they have reached debt rescheduling agreements

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