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# *Sovereign Default in the Bretton Woods Era*

> The purposes of the International Monetary Fund are: (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems. . . .
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> *Article I, Articles of Agreement of the International Monetary Fund*

The machinery for sovereign debt workouts is part of a complex financial system within a more complex global political system. Many basic features of the international financial system predate World War II, but the current structure is the product of the United Nations Monetary and Financial Conference at Bretton Woods, New Hampshire, in July 1944. The principal architects, Harry Dexter White representing the United States and John Maynard Keynes representing the United Kingdom, designed a pair of institutions to anchor the system: the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD, or World Bank). Created as specialized agencies of the United Nations, they promote four systemic principles: the rule of law, market-based growth, removal of barriers to trade and payments, and stability.

The Bretton Woods system has not been a rigid one. Indeed, adaptability has been one of its hallmarks. The monetary system based on fixed exchange rates was recast as a floating-rate system in the 1970s. Regional development banks were created. Special programs and facilities were put in place to alleviate poverty in low-income countries. Changes in the system were also made in response to breakthroughs in communications and informa-

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tion technology, the creation of innovative financial instruments, and the emergence of global financial conglomerates.[1]

One measure of the success of the system has been the historically rapid growth of living standards recorded after 1944. Another was the decision by almost all of the communist countries in the 1980s and 1990s—which had opted out of the Bretton Woods system when it was first established—to abandon central planning in favor of market-based growth strategies.

The system has experienced a number of problems, however. Persistent poverty among a large portion of the world's population has been one of the biggest concerns, and frustrations, over the years. Another problem has been instability, manifested in financial crises in the developing countries that have seemed to grow worse in each succeeding decade. Informal and ad hoc machinery has been developed to restructure international debt when necessary to recover from these crises. The Paris Club was created in the 1950s to restructure debt owed to government agencies in the wealthier and more advanced countries. The London Club was created in the 1970s to restructure debt owed to commercial banks. Debt in the form of international bonds issued by developing country borrowers became significant—for the first time in the Bretton Woods era—in the early 1990s. Toward the end of that decade, several countries were unable to avoid restructuring their bond debt along with debt owed to Paris Club and London Club creditors. That situation sparked a lively policy debate about the kind of machinery that should be used to restructure bond debt, with one side favoring ad hoc machinery and the other favoring permanent machinery.

This study views the current debate about bond restructuring as the fourth global debate about the machinery for sovereign debt workouts in the Bretton Woods era. The policy issue at the core of each debate has been burden sharing—how to share the costs of a workout among the debtor country, private creditors (primarily bondholders and commercial banks), Paris Club creditors, and the multilateral agencies (the IMF, the World Bank, and the regional development banks). Protagonists in the current debate often refer to past experience to support particular arguments. Some of these references are factually wrong, and some of the arguments overlook

1. The liberal financial system was designed to support and be reinforced by a liberal trading system managed through a sister institution to be called the International Trade Organization (ITO). Cold war politics blocked the establishment of the ITO, but the General Agreement on Tariffs and Trade (GATT)—adopted in 1947 by the noncommunist nations—was quite successful in liberalizing trade in goods and services. Following the end of the cold war, the World Trade Organization (WTO) replaced the GATT in 1995. Most of the former communist countries became members of the IMF and the World Bank in the early 1990s and began to join the WTO later in the decade.

relevant experience. The hope is that this study will help participants in this debate—and future ones—be better informed. The belief is that the lessons of the past fifty years point the way toward a pragmatic, middle-of-the-road approach. Ad hoc machinery can continue to produce sensible bond restructuring arrangements that enable sovereign borrowers either to avoid a default or to cure one.

The first debt debate took place in the 1970s as part of the North-South Dialogue. The less developed countries of the South, organized in the United Nations as the Group of Seventy-Seven (G-77), tried to leverage their numbers in various forums to rewrite the rules of the Bretton Woods system in their favor. The more economically advanced countries of the North fought to defend the existing system, where weighted voting works to their advantage. The North prevailed but made a number of concessions to defuse the tension and reinforce global support for the Bretton Woods system.

The G-77 campaign included a frontal attack on the Paris Club. The developing countries demanded a process that would be more sensitive to debtor country interests and proposed the creation of permanent machinery in the form of an International Debt Commission to ensure speedy and fair debt relief. The advanced countries resisted this proposal but agreed to make the Paris Club's operating principles transparent and to invite the secretary general of UNCTAD (United Nations Conference on Trade and Development) to send an observer to all Paris Club negotiations.

The second debt debate was fueled by the 1980s debt crisis that struck Latin American countries with particular force. This time the focus was on debt owed to commercial banks, and it was a "systemic" crisis. The outstanding loans of the world's biggest banks to developing countries were a multiple of the capital on the banks' balance sheets. Writing down these loans at the onset of the crisis to reflect their current market value would have reduced bank capital to the point of risking serious disruption in the international financial system and a global economic depression. The financial authorities in the major creditor countries adopted a strategy to buy time until the banks were able to accumulate enough capital to absorb these losses.

For seven years following the Mexican crisis in August 1982, the commercial banks repeatedly rescheduled principal payments and extended new loans sufficient to enable the countries concerned to stay current on their interest payments. These arrangements were negotiated in the London Club, an informal process loosely resembling the Paris Club process. Politicians, academics, and financial industry representatives advanced numerous proposals during this period for more rapid and definitive workouts. Most of

the proposals involved shifting the risk of future defaults to public sector institutions in return for slashing the size of the claims. Instead, beginning in 1989, a cooperative approach was adopted that involved sharing the burden among debtor countries, commercial banks, creditor countries, and multilateral agencies on a case-by-case basis.

The third debt debate began toward the end of the 1980s and extended well into the 1990s. The debt reduction deals with commercial banks generally succeeded in restoring the creditworthiness of the major debtor countries. Repeated Paris Club reschedulings for a group of forty to fifty low-income countries were not achieving the same result, however. These countries had large debts to multilateral and bilateral agencies but owed relatively little to commercial banks. The Paris Club reached the point of rescheduling everything it possibly could on increasingly generous terms, and even writing off some debt, but still these poor countries had difficulty meeting their debt-service obligations. The crux of the problem was the practice of treating multilateral agencies as preferred creditors, meaning that they never rescheduled or reduced their claims.

Public pressure to ease the burden of debt on the HIPCs (heavily indebted poor countries) escalated until the major creditor countries—which also held a majority of the votes in the multilateral agencies—finally launched a program in 1996 to fix the problem. The HIPC Initiative was a generalized approach to debt reduction designed to ensure that excessive external debt-service obligations would not prevent the poorest countries from meeting the basic needs of their people. Fundamentally, this debate was more about the world's "aid machinery" than about the machinery for restructuring debt. Nevertheless, it was a major preoccupation of financial officials in the 1990s, and a major source of confusion in the latest debt debate. Consequently, the story behind the HIPC Initiative must be told to complete the history of sovereign debt workouts in the Bretton Woods era.

The fourth and current debt debate began in 1995. The Mexican peso crisis at the end of 1994 sparked the debate. To prevent a default that might ripple through other major developing country borrowers and become a systemic crisis, the United States and its major creditor country partners mobilized an exceptionally large package of official financing to tide Mexico over until a program of economic reforms restored the country's ability to borrow in international capital markets. The package was sharply criticized for "bailing out" private creditors and thereby creating an incentive for more imprudent lending. Importantly, the private creditors involved were no longer commercial banks. Much of the banks' exposure had been converted

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to bonds that were actively traded in secondary markets and held by a broad community of investors. Moreover, developing countries started to issue new bonds in international capital markets on a large scale in the early 1990s, ending a period of almost sixty years when they had borrowed very little in the form of bonds.

A series of financial crises and defaults between 1994 and 2001, culminating in Argentina's spectacular default, prompted an intense global debate about how to prevent crises and how to share the workout burden in those that could not be avoided. The debate naturally focused on the Paris Club and the London Club. On one side were those who advocated making incremental improvements in this machinery, supported by other reforms such as introducing clauses in bond covenants that would facilitate restructuring. On the other side were those who advocated establishing some form of permanent machinery for ensuring orderly workouts. Remarkably, the IMF became the leading advocate of the second, more radical approach. In November 2001 First Deputy Managing Director Anne Krueger gave a speech proposing the creation of a Sovereign Debt Restructuring Mechanism (SDRM) to facilitate the restructuring of bond debt. Representatives of the private sector reacted with horror for the most part. The debate intensified in 2002 as the IMF refined its proposal and the private sector sharpened its criticisms. In April 2003, however, the debate moved into a less intensive phase when the U.S. position changed from support for studying all options to making incremental improvements in the existing system.

The thrust of the argument in this study is that permanent workout machinery is not necessary or desirable at this time. The Paris Club and London Club were both created "organically" in a series of negotiations over several years. First the bilateral donor agencies developed the Paris Club process; subsequently commercial banks developed the London Club process. In neither case were these pieces of machinery designed ex ante by the IMF or any official body and presented to the creditors to be used in future workouts—as the IMF is seeking to do with the SDRM. Past experience suggests that the bondholders themselves, represented by leading asset managers and institutional investors, can develop effective workout machinery for bond debt by themselves. Indeed, they will have a strong incentive to do so in 2003 if a new government in Argentina initiates serious negotiations with its creditors.

The subject of sovereign debt workouts is highly technical. Consequently, the book begins with three chapters explaining the jargon, describing the main players, and examining several basic policy issues. Readers who are

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familiar with the international financial system can skip these chapters. Chapter 2 on fundamental concepts touches on certain economic aspects of lending across borders. The legal systems for enforcing loan agreements and bond contracts are a critical part of the story and are introduced here. This discussion leads into an examination of domestic bankruptcy regimes and how they differ from various sovereign bankruptcy regimes that have been proposed. In today's system, specific categories of debt are restructured in the Paris Club, other categories in the London Club, and a few are exempt from restructuring. A chart is provided to explain what goes where. The extensive and sometimes confusing vocabulary associated with the business of restructuring is reviewed. Finally, the major sources of debt statistics are noted.

Chapter 3 focuses on the main players, beginning with the finance ministers from the seven major industrial countries (Group of Seven, or G-7), who collectively have assumed responsibility for the design and management of the international financial system. They dominate the process of establishing policies related to sovereign debt workouts and implementing strategies for dealing with specific cases. In this study they are usually referred to as the G-7 architects. Brief descriptions of the major categories of lenders and borrowers are also provided.

Chapter 4 on fundamental issues is a series of short essays on critical or controversial aspects of the workout business. It begins with a discussion of the way respect for contractual obligations relates to the rule of law, one of the four principles of the Bretton Woods system. The efforts made in recent years to prevent crises are noted, and the work that remains to be done in this area is stressed. Approaches to restructuring in specific cases often turn on assessments of a country's ability and willingness to meet its external payment obligations. That in turn relates to a policy choice between financing and adjustment and reveals a paradox at the heart of the workout process. All sovereign workouts have a political dimension that is largely absent from domestic workouts. Finally, the latest debate has been driven by concerns about using public sector resources to "bail out" private creditors, but a greater concern may be that private creditors will end up "bailing out" the public sector.

Chapters 5 and 6 respectively focus on the origins and operations of the Paris Club and the London Club (or Bank Advisory Committee process). A pair of essays on the Paris Club published by this author in 1984 and 1985 have been expanded and updated here, with special attention paid to the Paris Club's approach to burden sharing. The origins and operations of the

London Club process have never been thoroughly documented. As a consequence, the material in chapter 6 may be of particular value. For both these chapters, the author has drawn heavily on first-hand sources. In this connection a list of the chairmen, cochairmen, and secretaries general of the Paris Club is published for the first time, together with a corresponding list of selected Bank Advisory Committee chairmen and cochairmen.

The next three chapters examine each of the first three debt debates in the Bretton Woods era. Chapter 7 focuses on the North-South Dialogue, where an earlier attempt was made to establish permanent machinery for sovereign debt workouts. Chapter 8 examines the debt crisis of the 1980s, with particular emphasis given to the close cooperation between finance officials and the commercial banking community that was a hallmark of this period. Chapter 9 looks at the debate about how to alleviate the debt burdens of the poorest countries and seeks to differentiate the HIPC Initiative from the business of sovereign debt workouts.

The current debt debate is addressed in the following two chapters. Chapter 10 briefly reviews the financial crises that occurred from 1994 through 2002. Chapter 11 tracks how the approach of the G-7 and the IMF to "private sector involvement" (PSI) evolved during this period, and how the private financial community responded.

The final chapter addresses two questions: what is broken in the current system, and what needs to be fixed. The major problem found is the absence of a clear and predictable workout process for cases where much of the debt that must be restructured is in the form of bonds. The recommended solution is for the G-7 and the IMF to actively support efforts by private creditors to develop new machinery through a series of actual cases, building on the foundations of the London Club experience, and in the context of a "tools-based" approach to sovereign debt restructuring. A smaller problem is the Paris Club's approach to burden sharing. Here the recommendation is that the Paris Club adopt a more flexible and forward-looking approach.

From beginning to end, this book is about policy choices, not economic theories or financial principles. The international financial system, as well as the machinery for sovereign debt workouts that is embedded in the system, are the product of political compromises. The science of economics and the art of finance have not advanced to the point where the "right" answer to a problem can be clearly identified. Reasonable people and well-informed experts can find strong arguments for quite different approaches. Even when a consensus is reached on a course of action, the results can be disappointing

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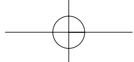



due to misunderstandings, miscalculations, or unintended consequences. Experience, then, can be especially important in selecting among policy options. The hope is that this study will help policymakers and policy advocates make substantial and lasting improvements in the machinery for sovereign debt workouts.