Edwin M. Truman *Debt Restructuring: Evolution or Revolution?*

THE PAPERS BY BULOW, Sachs, and White illustrate the interconnections inherent in most important economic policy issues, not least those concerning the structure of the international financial system. One of the most timely of these issues is whether there should be an international bankruptcy court for sovereign debt. Two of the three papers in this symposium, those by Bulow and Sachs, provide brief answers to that question within a more expansive essay on what is wrong with the international financial system. Both argue that a thorough reform of the system is needed; a bankruptcy court is an important side issue in Sachs' view and a distraction in Bulow's. There are some similarities in their critiques, but they differ fundamentally on the central issue of sovereign debt. Sachs wants governments to provide more financial resources to heavily indebted countries, including through the international financial institutions (IFIs) and streamlined debt relief, to give those countries a fresh start. Bulow wants governments and markets to provide fewer resources because national and international institutions have squandered what has been provided in the past, and he argues further that those institutions should first be largely privatized. Sachs and Bulow cannot both be right in their prescriptions for the international financial system. My judgment is that they are both mostly wrong, but that is for another day.

Bulow and Sachs in their papers do provide a service. They remind us that the issue of sovereign debt is connected with the structure of economic institutions and incentives for sound policies. Sachs also implicitly reminds us that a well-functioning international financial system must deal with countries that differ in their economic and financial circumstances over time and across a broad continuum. Not all are perennial financial basket cases. At least four of the countries that Sachs identifies as having chronic, continuing debt crises—Bolivia, Côte d'Ivoire, Ecuador, and Nigeria—were borrowers in international financial markets on commercial terms not so long ago. Further along the continuum, Turkey is not a new member of the club of advanced industrial countries (the Organization for Economic Cooperation and Development) whose external financial crisis, like Mexico's or Korea's, demonstrates at least to some that it should not have been admitted; Turkey has been a member of the club for many years. Finally, during the era of floating exchange rates, even Italy, the United Kingdom, and the United States have borrowed from the International Monetary Fund. Circumstances change, and thus to consign all current basket cases permanently to the international welfare rolls is fundamentally flawed as an initial premise.

I would like to address the issue of international bankruptcy arrangements by posing three questions. First, is an international bankruptcy court an appropriate solution to problems of sovereign debt? Second, what are the connections between this concept and recent proposals for a so-called sovereign debt restructuring mechanism (SDRM)? And third, should we expect revolution or evolution going forward?

Bulow's answer to the first question is no: although the SDRM proposals may be a step in the right direction, a bankruptcy court is unnecessary. Sachs' answer is yes: such a court is needed to give countries a fresh start. White says the analogy to domestic bankruptcy procedures is weak, but a court or the equivalent may be needed if we are serious about solving the three basic problems in this area that she and others have identified: reining in rogue creditors, providing seniority for private sector financing to countries while their debts are being restructured, and forcing closure on the parties.

My own view is that an international bankruptcy court for sovereign debt would be useful in addressing these problems, and it would be desirable (largely for the reasons advanced by Sachs), but it is not now feasible. It is closer to being feasible today than when I participated in drafting the Group of Ten's 1996 report (the Rey Report), but it is still not feasible because the intellectual and political foundations have not yet been laid. First, a consensus is still lacking about the economic principles upon which such an institution should be based. For example, should it seek to maximize the return to creditors or seek to give debtors a fresh start? Second, political consensus is lacking. Sachs writes, "for hundreds of years, sovereign borrowers have experienced repayment crises, including defaults and restructuring of debts" without such an institution. The world is not ready to turn over such judgments—and judgments are what would be required—to a supranational body.

Addressing the second question, Anne Krueger has proposed, most recently in a speech given just days before this conference, an SDRM-lite with a statutory (or treaty) base.[1] The following day John Taylor proposed an SDRM-very-lite in the form of a decentralized, market-oriented approach without an international statutory base.[2] I would submit that neither proposal offers much promise with respect to the fundamental problem, which both Krueger and Taylor identify as inducing countries to recognize sooner than they do now that their external debts (I would say "external financial circumstances") are unsustainable.

The Taylor approach, relying on the widespread, semivoluntary inclusion of a set of workout clauses in cross-border financial contracts, falls short on four crucial tests. First, it does not envision including such clauses in the debt instruments of the U.S. government; consequently, it fails to acknowledge that, when dealing with the global financial system, a global solution is needed. Second, the proposal does not envisage that sovereign borrowers would include such clauses in their domestic obligations; consequently, such a mechanism would have been able to address only one (Argentina) of the eight major external financial crises of the past eight years (in order of occurrence, Mexico, Thailand, Indonesia, Korea, Russia, Brazil, Turkey, and Argentina). Only the Argentine, Mexican, and Russian crises involved principally sovereign debt, and only the Argentine crisis involved principally sovereign debt issued on international markets; most of the Russian and Mexican sovereign debt was issued under domestic law. (Bulow is off the mark in reiterating his analysis of the bias introduced in lending to sovereigns by the coverage of most such lending by U.K. or U.S. law. There may have been such a bias in the 1980s, but not in the 1990s.) Third, the Taylor approach includes inadequate incentives to force the inclusion of such clauses in all relevant financial contracts, and therefore it is incomplete. Fourth, it would not apply retroactively, and therefore its relevance is only to the distant future.

The Krueger approach also fails the second test, for it, too, would not in its current form cover sovereign debt issued under domestic law. (Krueger states that it would be for consideration on a case-by-case basis whether domestic debt should be covered by the mechanism, but that elides the fundamental point. Unless the SDRM-lite embodies as a matter of law the potential legal capacity to override domestic law governing the

1. Krueger (2002).
2. Taylor (2002).

issuance of sovereign debt in domestic markets, national laws will normally not allow such debt to be reached.) Thus it, too, would have dealt with only one of the past eight crises. It addresses the third and fourth tests by proposing an international treaty, in the form of an amendment to the IMF Articles of Agreement, that would override national law. Her approach, in effect, would establish an international sovereign bankruptcy court outside the auspices of the IMF. However, the Krueger mechanism would not involve an enforcement procedure either in White's sense (forcing a solution on the debtor country and its creditors if they cannot agree) or in Bulow's sense (forcing the debtor country to abide by the terms to which it and its creditors have agreed). But even Krueger's SDRM-lite is not likely to be adopted; the authorities of each IMF member country would have to agree to allow the new institution to override their national laws. And again the benefits of the proposed radical solution would apply at most to fewer than 15 percent of future crises. I say "at most" because we should expect the international financial system to adapt to a regime with an SDRM-lite by further reducing the amount of obligations that would come under its jurisdiction.

The fundamental failure with both approaches, however, is that they do not deliver on what they claim with respect to the basic issue, namely, inducing a country to address its external financial situation promptly. (I use the word "situation" to incorporate not just external sovereign debts, and not just sovereign debts, but at least the full and diverse range of circumstances experienced in the eight principal external financial crises of the past decade.) For countries to do so, both the international financial community (acting through the IMF) and, more important, the debtor country itself would have to agree that the country's external financial situation is unsustainable. In none of the recent cases did the debtor country reach such a judgment on its own, and the international financial community did so only once, in the case of Argentina in August 2001. The reason is that these are very complex judgments about external financial sustainability; they are further complicated in that, as Taylor correctly states, "The aim of reforming the sovereign debt restructuring process is not to reduce the incentives that sovereign governments have to pay their debts in full and on time."[3] In other words, it is unfortunately unrealistic at this time to think that countries are going to get Sachs' "fresh start" before

3. Taylor (2002, p. 2).

they have suffered for a long time; defaults, de facto stays, and restructurings will remain a late resort, and restructurings will continue to be incomplete on Sachs' terms.

Finally, should we expect revolution or evolution in international workout procedures? My earlier comments imply that one should not expect revolution in the form either of Krueger's SDRM-lite, Taylor's SDRM-very-lite, or Sachs' debtor-friendly court. Instead we should expect further *continued* evolution. I stress "continued" because, unlike Bulow, who indicates that he has learned nothing since 1992, policymakers have learned a good deal over the past decade, and the international financial system has already evolved substantially. For example, in 1995 Sachs wrote, "it is understood that bonds are not rescheduled, so that new bond financing would in practice have administrative priority over rescheduled bank debt."[4] We have learned that that statement was untrue, and we have learned that it was unfortunate that some borrowers and creditors believed it was true.

Aside from the difficult issue of external financial sustainability, the central argument of those favoring substantial reform of the sovereign debt workout process is that there is a creditor coordination problem that must be addressed. I believe that proposition has yet to be demonstrated in practice, and I interpret Bulow as having reached the same conclusion in theory when he asks "why such coordination requires international intervention." Financial market participants, in general, do not think that they have coordination problems.

Going forward, once Argentina establishes a credible financial program that has the support of the IFIs, it will address its external debt problems. We then will learn a great deal, including about creditor coordination problems. If market participants want the authorities to appreciate that coordination problems are minor or can be reasonably overcome, then the major participants should demonstrate that fact in the Argentine case. If they fail to do so, the issue of an improved SDRM-lite will be revisited. In the meantime it will be in the interests of market participants also to take seriously Taylor's SDRM-very-lite proposal, because that is a steppingstone to SDRM-lite.

In the end, however, these are matters of balance. No solution deals with all dimensions of all problems. Each intervention by the authorities—

4. Sachs (1995, p. 12).

and each nonintervention by the authorities—blunts some incentives, reducing optimal efficiency. Policymakers should listen to academics about incentives and the effects of various proposed policies on incentives, but the policymaker's task is to exercise judgment and to seek a balance, which has more to do with political processes than economic theory. Policymakers should be informed by theory and by history and experience. But in the end, they must exercise judgment.

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