Private vs. Official Creditors: The Record Speaks

Arturo C. Porzecanski

American University

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Abstract: *Here we highlight the contribution that private creditors have made to resolve expeditiously and even generously the many sovereign debt crises in which they have been involved. The road from debt restructuring to debt forgiveness – from reprofiling to cancellation, in the jargon of the official community – has been a fairly short one for commercial banks and bondholders, but a very long one for the official export-credit and foreign-aid agencies represented by the Paris Club, as well as for the multilateral agencies such as the World Bank and the IMF. They have yet to grant any debt reduction to the middle-income countries that were the object of bailouts during the 1990s and the recipients of subsequent debt relief from the private sector, and they have moved far too slowly to address the needs of the poorest countries, many of which have received substantial, upfront and unconditional debt forgiveness from private creditors.*

During the 1990s and earlier this decade, certain academic scribblers on both sides of the Atlantic, plus policymakers in Washington, London, and beyond, flogged the idea that the functioning of the world's financial markets had to be improved, by making it easier for governments in unstable emerging markets to obtain debt relief from their private creditors in times of financial distress. A variety of proposals envisaged creating a new legal regime for sovereign bankruptcy, achieved through an international treaty buttressed by amendments to existing national bankruptcy codes. It would empower a supranational entity to render Solomonic judgments about the illiquidity or insolvency of sovereigns, overriding all outstanding loan and bond contracts.[1]

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* Scholar of International Finance In Residence, American University, and Adjunct Professor of International Affairs, Columbia University; e-mail: aporzeca@american.edu

The best known of these was the Orwellian construct of a supranational "Sovereign Debt Restructuring Mechanism" (SDRM) to operate under the aegis of the International Monetary Fund, which was conceived in 2001 and was subsequently modified during 2002-03 by a self-serving IMF.[2] In the face of universal criticism from private-sector lenders and investors, and also from leading emerging-market governments such as Mexico's, the proposal ultimately failed to attract the requisite political support from the U.S. and others. Besides, at the time the world economy was looking up and no new sovereign disasters – at least not with systemic implications – appeared to be in the making. Argentina, which had defaulted at the end of 2001 despite having received good marks and huge loans from the IMF, was eschewing the traditional, collaborative approach and was crafting its own, unilateral restructuring of debt obligations. Lastly, the threat of an SDRM coming to pass was persuading investors and sovereign issuers alike to introduce new collective-action clauses into bond contracts, with the goal of facilitating future debt restructurings.

The ostensible rationale for all the brainstorming on the part of policymakers and their academic consultants was to ameliorate the supposedly undesirable consequences of having bailed out, during the 1990s, a number of troubled sovereign debtors (e.g., Mexico in 1995 and various Asian countries, Brazil and

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[1] See Kenneth Rogoff and Jeromin Zettelmeyer, "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001," *IMF Staff Papers*, Vol. 49 #3 (2002), pp. 470-507.

[2] See Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring* (Washington, D.C.: International Monetary Fund, April 2002); and Sean Hagan, "Designing a Legal Framework to Restructure Sovereign Debt," *Georgetown Journal of International Law,* Winter 2005, pp. 299-402.

Russia in 1997-98). Stung by criticism of having encouraged reckless investors and overindebted countries to come knocking at their door pleading for truckloads of money, the U.S. and other governments reportedly wanted to open up an alternative – a fast track to default, debt forgiveness, and financial resurrection. Thus, when in the future a government under financial duress came looking for massive financial help, it would no longer be able to claim that the only alternative to a bailout was a hopelessly disruptive, delayed, and uncertain default with potential spillover effects around the globe. With some kind of sovereign bankruptcy process in place, Washington and its G7 partners would feel free to tell that government that it should seek debt relief from its private creditors, availing itself of the supposedly quick, orderly and painless debt-restructuring mechanism.

A more cynical interpretation of all this intellectual and policymaking brouhaha is that, during the 1990s and earlier this decade, the US and its Canadian, European and Japanese partners purposely kicked up the SDRM storm – to divert public attention from their own reluctance to accept loan losses and grant debt forgiveness, whether to overindebted middle-income nations or to the poorest countries in the world. To this day, the official export-credit and foreign-aid agencies represented by the Paris Club, as well as the multilateral agencies (such as the World Bank and the regional development banks – never mind the IMF), have yet to grant any debt cancellation to the middle-income countries that were the object of bailouts during the 1990s and the recipients of subsequent debt forgiveness from the private sector.[3] As concerns debt reduction in low-income countries (via the HIPC Initiative of 1996, as enhanced in 1999 and supplemented by the MDRI in 2005), it has taken a full decade for not even 20 countries to reach the so-called completion point at which they finally get the debt forgiveness committed to them previously.[4] Consequently, dozens of exceedingly poor countries remain burdened with unsustainable debts that tie up the budgetary resources needed to fund poverty reduction initiatives.

Indeed, in the wake of the punishing, unilateral debt restructuring by Argentina that three quarters of its bondholders were compelled to swallow in 2005, a case can be made that, if anything, international reforms should focus on making contracts easier to enforce by paring back the protections sovereign debtors are currently afforded, for example under the U.S. Foreign Sovereign Immunities Act.[5] The main reason corporations that cannot pay their creditors subject themselves to wrenching, court-supervised reorganizations is because the frightening alternative is their outright liquidation. Sovereign governments, in contrast, do not operate under the threat of liquidation, and despite the strong rights that private creditors have on paper (under New York, British and other law), practical experience – reinforced by the ongoing case of Argentina – proves

[3] As discussed below, in a handful of unique cases of political importance to the U.S. (involving Egypt, Iraq, Poland and the former Yugoslavia), and in the recent case of Nigeria, the Paris Club did grant various levels of debt forgiveness, but none of the countries involved had been the object of a massive bailout.

[4] See Development Committee of the World Bank and IMF, "Heavily Indebted Poor Countries Initiative (HIPC) and Multilateral Debt Relief Initiative (MDRI): Status of Implementation," September 7, 2006, available at http://siteresources.worldbank.org/DEVCOMMINT/Documentation/21046514/DC2006-0016(E)-HIPC.pdf.

that the enforcement of claims against sovereign governments is exceedingly difficult. Whereas delinquent corporations can be hauled, de jure and de facto, before a bankruptcy court and be forced to change management, restructure operations, dispose of assets, or even liquidate to pay off claims, governments are not subjected to any of that. Much as the storybook child who blurted out the truth about his Emperor being naked, a rogue sovereign debtor like Argentina has single-handedly managed to undermine the integrity of the international financial system, exposing its inherent fragility for all to see.[6]

FROM THE MID-1950s TO THE LATE 1980s

The road from debt restructuring to debt forgiveness – from reprofiling to cancellation, in the jargon of the official community – has been a fairly short one for private creditors but a very long one for the two kinds of government lenders: bilateral creditors, mainly export-credit and foreign-aid agencies (such as the U.S. Ex-Im Bank and AID, and their equivalents in other countries) and multilateral creditors, such as the World Bank, the regional development banks (e.g., the African, Asian, European, and Inter-American development banks) and the IMF.

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[5] See Hal S. Scott, "Sovereign Debt Defaults: Cry for the United States, not Argentina," *Washington Legal Foundation Working Paper #140,* September 2006, available at http://www.wlf.org/upload/Scott%20WP%20Final.pdf.
[6] See Arturo C. Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default," *Chicago Journal of International Law,* Summer 2005, pp. 311-332.

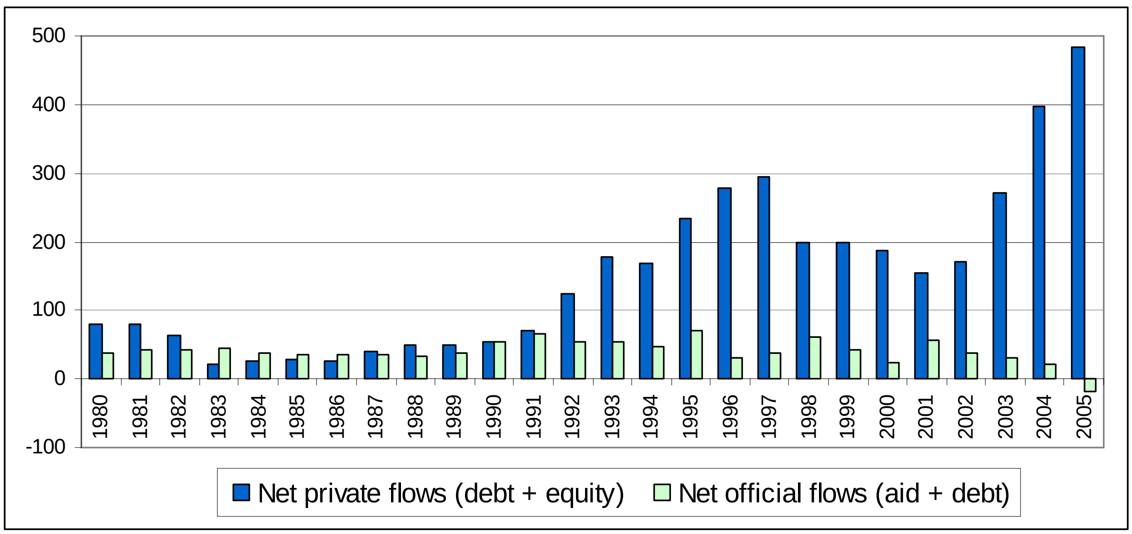
It was in 1955 that six European countries decided to pursue a joint approach to clearing financial obligations that Brazil had built up with them, and they did so by meeting in The Hague. Within a year's time, a similar gathering involving even more European countries took place in Paris, this time to deal with $500 million of Argentine debts coming due after the overthrow of the Juan Domingo Peron regime. While more than a decade would have to pass before France established an effective monopoly over the process of restructuring debt owed to government agencies (including newcomers Canada, Japan and the U.S., during the 1960s), what we now know as the Paris Club evolved as a pragmatic rather than a planned solution to the problem of overly burdensome sovereign debts.[7]

In the second half of the 20th century, the balance of payments deficits of the developing countries went from being financed mainly by government agencies in the industrialized countries to being underwritten largely by private-sector lenders and investors, mostly from those same industrialized countries. From the creation of the Paris Club until the mid-1970s, the main external financing flows were provided by official foreign aid and trade-credit agencies, or else by multilateral lenders such as the World Bank and the IMF. In this first phase, when developing countries encountered external financial problems, they would go to the IMF for assistance in the preparation and implementation of a stabilization program, which was underwritten by a short-term loan from the Fund, and then they would sit down with their bilateral creditors in Paris to work out debt relief

[7] See Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington, DC: Brookings, 2003), pp. 56-94.

along what is known as “Classic” terms. Credits previously granted by foreign aid and export credit agencies were rescheduled at market interest rates with a principal repayment profile negotiated on a case-by-case basis. The loans made by multilateral agencies were not similarly restructured, as they were granted de facto top seniority in the chain of cross-border payments. Private creditors (mainly banks and suppliers) were often unaffected because of their limited exposure to these developing countries.

Chart 1: External financing to all developing countries ($ billions)



Source: World Bank, Global Development Finance, various issues.

From the mid-1970s to date, however, private-sector lenders and investors – commercial banks at first, then bondholders and equity investors – have underwritten all but the poorest and most mismanaged developing countries (see Chart 1). When commercial banks were the largest providers of external finance (from the mid-1970s until the early 1990s) and a country found itself in financial difficulties, it would likewise turn to the IMF for guidance and financial support –

but then it would sit down with its commercial bank creditors to work out a mutually acceptable debt rescheduling. These meetings would largely take place either in New York (involving Latin American countries) or in London (involving Eastern European, Middle Eastern and African countries) – giving rise to the term "London Club" for another ad hoc process of debt negotiations that would be refined through time.[8] The Paris Club would then chime in with a debt restructuring along its Classic terms, and the multilateral agencies would pledge substantial new lending in lieu of any reprofiling of their existing loans.

FROM THE LATE 1980s TO DATE

In the late 1980s, however, after a number of countries (particularly in Latin America) had gone through multiple debt restructuring exercises which still left them overindebted, the U.S. government came up with what became known as the Brady Plan, named after the then U.S. Secretary of the Treasury. The commercial banks (London Club) were pressured into granting sizeable, permanent debt forgiveness, and to do so by exchanging existing loans for long-term bonds issued by the developing countries, which incorporated either a reduction in the principal owed or below-market interest rates. The principal of these "Brady" bonds was often guaranteed and a rolling portion of the coupon payments was collateralized. To come up with the requisite collateral, the debtor governments would purchase high-quality securities (including zero-coupon bonds issued by the U.S. Treasury), supplementing their own resources when

[8] Rieffel, op. cit., pp. 95-131.

needed with loans from the IMF and the World Bank. In addition, the countries would commit to economic reforms underwritten in part by the multilateral agencies. Nevertheless, all of the debt forgiveness was granted upfront by the private creditors, and was neither conditioned on need as determined by the banks – the extent of debt relief was essentially dictated by the IMF – nor on ongoing, good performance on the part of the sovereign debtors.

The Paris Club, in sharp contrast, did not grant any debt reduction to the countries that had obtained it from their commercial bank lenders under the Brady Plan, adhering to its usual debt reprofiling exercises. The only concession made, starting in late 1990, was to reschedule the obligations of lower middle-income countries under so-called Houston terms, featuring longer repayment periods and lower interest rates on foreign aid loans. Among the Brady Plan beneficiary countries that obtained said Houston terms during the early 1990s were Ecuador, Morocco, Nigeria, Philippines and Peru. All of the largest debtors, such as Argentina, Brazil and Mexico, however, had their Paris Club debt restructured under ordinary, Classic terms. The multilateral lending agencies, for their part, did not engage in any debt restructuring, even in the face of some protracted defaults (e.g., on the part of Peru), preferring instead to underwrite the developing countries, as noted, by making new loans in support of creditworthiness-enhancing reforms and the purchase of high-grade securities to back the Brady bonds.

In April and May 1991, this time it was the Paris Club, also under pressure from the U.S. government, that was persuaded to make an exception and grant permanent debt forgiveness to two countries, the first of which would end up issuing Brady bonds: Poland (considered middle-income) and Egypt (lower middle-income). Both obtained a halving of their financial obligations to the Paris Club measured on a net-present-value (NPV) basis, namely, combining debt write-offs with interest payments set below the creditors' cost of funds. The official rationale for this unprecedented gesture of financial support was that Poland had been of "strategic importance in the stabilization and transformation of Eastern European states to market-oriented democracies, and in recognition of the contribution of the Polish armed forces to the Allied victory in World War II," and that Egypt had played an "important role in the consolidation of a Gulf War coalition to expel Iraq from Kuwait."[9]

In Poland's case, the Paris Club, egged on by the United States, subsequently insisted that the Polish government obtain a comparable amount of debt forgiveness from its commercial bank creditors. The exposure of banks to Poland was half that of the Paris Club, but it was still quite large in absolute terms (almost $15 billion), and the London Club expressed strong reservations about this politicization of the debt restructuring process, particularly since the extent of debt forgiveness demanded seemed to be unwarranted. Three years later,

[9] See U.S. Treasury, "US Debt Reduction Activities FY 1990 through FY 1999," February 2000, available at http://www.ustreas.gov/press/releases/reports/debtreduct.pdf. The US government went beyond the Paris Club agreement and reduced 70 percent of Poland's obligations plus 100 percent of Egypt's military debt.

however, the banks caved in to the political pressure and agreed to a very generous debt deal under the Brady Plan that was deemed acceptable by the Paris Club. The multilateral agencies, meantime, did not depart from their tradition and granted debt forgiveness neither to Egypt nor to Poland.

In the late 1980s and throughout the 1990s, in fact, Paris Club operations began to move down two separate avenues: the one we have detailed, applicable to middle-income or lower-middle-income countries, ineligible for debt forgiveness except in the two special cases just noted; and another applicable to the lowest-income countries, which became eligible for progressively more generous amounts of debt reduction starting in late 1988. The reason official lenders moved down this second avenue is that mere reprofiling operations had exhausted the immediate cash-flow relief that could possibly be delivered to the poorest countries, and thus the creditors had to choose between increasing new commitments of foreign aid or agreeing to debt cancellation. Decisions on the extent of such forgiveness were made during various G7 summits, starting with one in Toronto in October 1988. "Toronto terms" authorized for the first time a reduction of one-third of the debt of poor countries, and 20 countries benefited from them between 1988 and 1991. In December 1991, Paris Club creditors agreed to implement a new treatment on the debt of the poorest countries along "London terms," which raised the allowable level of debt cancellation to 50 percent, and 23 countries benefited from these terms between 1991 and 1994.

In December 1994, the G7 governments agreed on still more debt forgiveness for lowest-income countries. These new “Naples terms” raised the potential cancellation level to 67 percent of eligible credits, and 35 countries had benefited from these terms through late 2006. In November 1996, in the framework of the initiative for “Heavily Indebted Poor Countries” (HIPC), the level of debt forgiveness was increased to 80 percent for the poorest countries with the highest indebtedness, and 5 countries qualified for these “Lyons terms.” Then, in November 1999, the Paris Club creditor countries, again within the framework of the HIPC initiative and in the aftermath of the Cologne Summit, accepted to raise the level of debt forgiveness up to 90 percent or more, and as of late 2006, 25 countries had benefited from “Cologne terms.”[10] Finally, in mid-2005, the G8 gathering proposed that three multilateral institutions (the IMF, the International Development Association (IDA) of the World Bank, and the African Development Fund) prepare themselves to cancel 100 percent of their debt claims on countries that have reached, or will eventually reach, the completion point under the Enhanced HIPC (September 1999).

However, progress on debt relief under the HIPC initiative has been painfully slow for two main reasons. First, official creditors have set eligibility criteria for debt cancellation according to evolving – and arguably incomplete and biased – standards as to what constitutes an unsustainable level of indebtedness. Initially, eligibility was based on two debt sustainability thresholds: the net present value

[10] The factual information cited in this and the prior paragraph was obtained from the website of the Paris Club, available at

(NPV) of the public foreign debt had to be equivalent to more than 200 percent of annual exports, and yearly debt service had to represent at least 20 percent of export earnings. In the wake of the Enhanced HIPC, these eligibility standards were loosened – the NPV of the public external debt had to be greater than 150 percent of exports – but the approach to debt sustainability did not change. Thresholds applicable to countries unusually open to foreign trade were likewise relaxed over time.[11]

It took many years for the World Bank and the IMF to react to criticism and adopt, in 2005, a new debt sustainability framework – a more comprehensive and forward-looking calculation, but also one that is more prone to bias and error. The new approach includes a determination of country-specific debt thresholds that considers domestic as well as external indebtedness, and varies depending on the quality of policies and institutions; an evaluation of economic vulnerability to external shocks; and the existence of a borrowing strategy that minimizes the risk of debt distress. The new framework is nevertheless subject to criticism because of its reliance on a series of subjective judgments and economic projections (e.g., of debt repayment capacity, government revenues and export growth), which are prone to optimistic biases on the part of official creditors. After all, besides being effectively governed by the creditor nations, the Bank and the

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http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B02WP03.

[11] For countries with open economies (an export-to-GDP ratio greater than 40 percent) and substantial tax revenues (greater than 20 percent of GDP), having an NPV of public debt-to-tax revenues above 280 percent was an initial, alternative condition for eligibility. These thresholds were later lowered to above 30 percent (for exports-to-GDP), greater than 15 percent (for revenues-to-GDP), and above 250 percent (for debt-to-revenues).

IMF are creditors themselves to the poor countries, which results in debt relief needs allegedly "being regularly calculated at a lower level than necessary."[12]

Second, official creditors have insisted that debt cancellation – no matter how badly needed – be conditioned on the application of stabilization measures and structural reforms over a period of many years. All that the Paris Club had expected of countries before granting them any debt relief was that they should have in place an agreement with the IMF specifying an agenda of stabilization and reform measures. The original HIPC initiative required countries not only to have successfully met the requirements of an IMF program for three years in order to reach the so-called decision point, but to remain in compliance for a further three years in order to reach the "completion point." The Enhanced HIPC went beyond this to establish an additional conditionality: countries had to come up with a strategy for reducing poverty, including via higher government spending (as laid out in a "Poverty Reduction Strategy Paper" or PRSP), and had to begin implementing it between the decision and completion points, subject to IMF/World Bank monitoring. In sum, the timetable for progress was no longer limited to three years but, rather, was stretched out for many more years – it is now called a "floating timetable" – dependent on the nature and pace of progress

[12] See Eurodad, *To Repay or to Develop? Handbook on Debt Sustainability* (Brussels: Eurodad, April 2006), p. 8, available at http://www.eurodad.org/uploadstore/cms/docs/HandbookEnglishfinal.pdf. See also Henry Northover, *To Lend or to Grant? Critique of IMF/World Bank Approach to Debt Sustainability* (London: CAFOD, April 2004), available at http://www.cafod.org.uk/var/storage/original/application/phphQhUd5.pdf; and Marco Arnone, Luca Bandiera and Andrea F. Presbitero, "External Debt Sustainability: Theory and Empirical Evidence," draft, 2005, available at http://www3.unicatt.it/unicattolica/Dipartimenti/DISES/allegati/ArnoneBandieraPresbitero33.pdf**.**

as judged by the multilateral agencies. The conditionality attached to debt relief has thus become more comprehensive over time, and far more elaborate and subjective than envisaged by the original HIPC – never mind as practiced for many years by the Paris Club.[13]

Recent economic research suggests that, contrary to the immediate, massive, and unconditional debt forgiveness granted by private creditors under the Brady Plan in the late 1980s and early 1990s, the piecemeal, delayed and highly conditional debt cancellation granted by official creditors in recent years has had little positive impact.[14] One empirical study examined the economic performance of countries that have been the recipient of HIPC-related relief, versus those that have not been included in this debt cancellation initiative, and concluded that the

[13] See Geske Dijkstra, " Debt Relief from a Donor Perspective: The Case of the Netherlands," in *HIPC Debt Relief: Myths and Reality,* ed. by Jan Joost Teunissen and Age Akkerman (The Hague: FONDAD, February 2004), pp. 109-131, available at http://www.fondad.org/publications/hipc/Fondad-HIPC-Chapter7.pdf. Slippage in the achievement of fiscal objectives, privatization targets and governance improvements are the most frequent causes of program delay or breakdown. See Jubilee Debt Campaign, *Tightening the Chains or Cutting the Strings? The Status of HIPC Conditionality in 2006* (London: Jubilee Debt Campaign, September 2006), available at http://www.jubileedebtcampaign.org.uk/?lid=2341. On the unacceptably high and rising number of conditions that poor countries must meet (e.g., 67 conditions per World Bank loan, on average), see Eurodad, *World Bank and IMF Conditionality: A Development Injustice* (Brussels: Eurodad, June 2006), available at http://www.eurodad.org/uploadstore/cms/docs/Microsoft_Word__Eurodad_World_Bank_and_IMF_Conditionality_Report_Final_Version.pdf. However, the World Bank's count is an average of 12.5 conditions plus 32 nonbinding benchmarks per operation in poor (IDA) countries, with conditions dropping steadily since 1999 and benchmarks rising sharply since 2002. See World Bank, *Development Policy Lending Retrospective* (Washington, DC: World Bank, July 7, 2006), pp. 16-19, available at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/07/14/000012009_20060714104555/Rendered/PDF/367720rev0pdf.pdf.

[14] "In the 1980s, debt relief under the 'Brady Plan' helped to restore investment and growth in a number of middle-income developing countries. However, the debt relief plan for the Heavily Indebted Poor Countries (HIPC) launched by the World Bank and the IMF in 1996 has had little impact on either investment or growth in the recipient countries." See Serkan Arslanalp and Peter Blair Henry, "Debt Relief," *NBER Working Paper #12187*, April 2006, p. 1, available at http://www.nber.org/papers/W12187.

GDP growth rates of the HIPC countries have not been boosted.[15] Another assessment of the extent to which debt relief has been successful (using a database measuring the present value of debt relief for 62 low-income countries) found little evidence that debt relief has affected the level and composition of public spending in recipient countries, or that it has raised GDP growth, investment rates or the quality of policies and institutions among recipient countries.[16] One reason may be that official debt relief has been provided in lieu of grants or new loans, such that there has been no significant increase in the net quantity of resources given to the HIPC countries.[17]

Another explanation for disappointing results is that, since the HIPC initiative forces the poor countries to reallocate the resources freed from debt service in favor of spending on poverty reduction programs, countries must still raise the same amount of budgetary revenues as they did prior to receiving “relief.” Indeed, according to the latest estimates by the IMF and World Bank, the 29 HIPCs that reached the decision point by mid-2006 had experienced a drop in debt-service payments equivalent to about 2 percent of their GDP between 1999 and 2005. However, their poverty-reducing expenditures had increased by almost 3 percent of GDP during that same time period.[18] In other words, HIPC does not deliver any cash-flow savings; it enables poor countries to increase

[15] “Debt stock relief [under the HIPC] … has no influence on growth independent of the sample used.” See Ralf Hepp, “Can Debt Relief Buy Growth?,” draft, October 2005, p. 2, available at http://www.econ.ucdavis.edu/faculty/ralfhepp/Research/Growth.pdf.

[16] Nicolas Depetris Chauvin and Aart Kraay, “What Has 100 Billion Dollars Worth of Debt Relief Done for Low-Income Countries?,” draft, September 2005, available at http://129.3.20.41/eps/if/papers/0510/0510001.pdf.

[17] See Arslanalp and Blair Henry, op. cit., pp. 9-10.

government spending on programs favored by donor governments – as opposed to saving the proceeds or spending them on programs preferred by local policymakers.[19]

ENTER THE BONDHOLDERS

From the mid-1990s until the present, bond and equity investors, in addition to commercial banks and private sector suppliers, have become the dominant source of financing for developing countries. The rise of large-scale bond issuance on the part of governments and corporations in the emerging markets was facilitated by the existence of the Brady bonds, which were gradually sold to institutional investors by the commercial banks who were the original holders. The increasingly active ownership and trading of these Brady bonds by risk-prone hedge funds, and later on by conservative mutual and pension funds, opened up a new investor base willing to take on credit exposures to middle- and lower-middle-income countries, in what was a bet on their potential economic success. As concerns the buildup of portfolio and strategic equity investments in the emerging markets, these flows were facilitated by the privatization of major utilities, industries and banks in many of the developing and transition countries, and by their generally welcoming attitude toward foreign investment. Even in sub-Saharan Africa, by far the world's poorest region, in recent years net private

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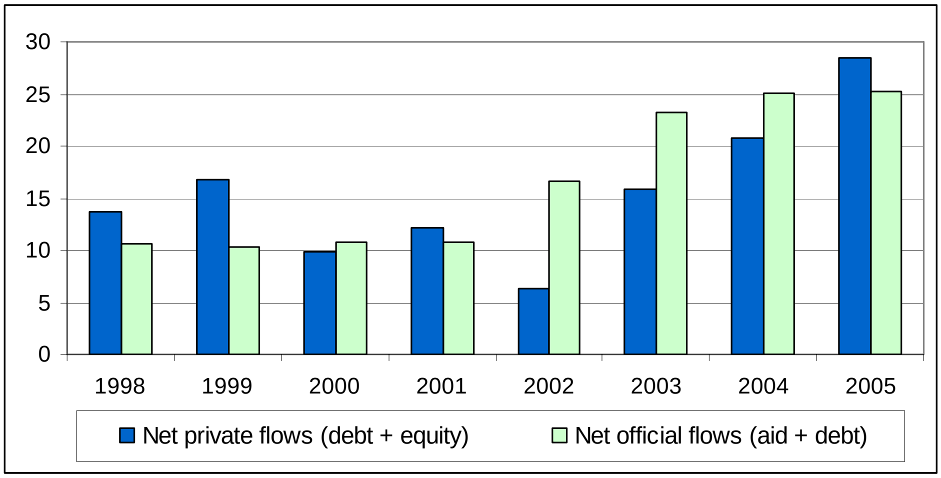
[18] Development Committee of the World Bank and IMF, op. cit., p. i.
[19] See Craig Burnside and Domenico Fanizza, "Hiccups for HIPCs?," *NBER Working Paper #10903*, November 2004, pp. 1-4, available at http://www.nber.org/papers/w10903.

flows of debt and equity finance have been just as substantial as net official flows of foreign aid and trade credit (see Chart 2).

Chart 2: External financing to sub-Saharan Africa ($ billions)



Source: World Bank, Global Development Finance 2006 (Washington, DC: World Bank, 2006), p. 179.

When various developing countries faced financial difficulties in the second half of the 1990s and also earlier this decade, they kept turning to the IMF for guidance and financial support – but afterwards their top priority was to find ways of restructuring their bonded debt, and not only their obligations to commercial banks. Because of the relative insignificance of debts falling due to official creditors, obtaining debt relief from the Paris Club became an option that was often bypassed. For example, during the Asian currency and debt crisis of 1997-98, Malaysia, Philippines, South Korea and Thailand never sought debt relief from their official creditors. Similarly, Mexico, Brazil and Uruguay did not turn to the Paris Club for any debt reprofiling in the wake of their financial troubles in

1994-95, 1998-99 and 2002-03, respectively – and neither did Turkey in 2000-02. These countries' bondholders and commercial bank creditors did not even attempt to precondition the debt refinancing and/or forgiveness they granted five of these countries (Brazil, Korea, Thailand, Turkey and Uruguay) to the simultaneous attainment of comparable debt relief from official bilateral – never mind multilateral – creditors, given the large infusions of new financing on the part of the IMF and other official lenders.[20]

The gesture was not reciprocated by the Paris Club when dealing with those developing countries that did knock at its door seeking debt relief during the past decade. For instance, when countries as diverse as Indonesia (1998), Pakistan (1999), Russia (1999) and the Dominican Republic (2004) encountered financial difficulties and reached out to their official creditors, the debt relief they obtained from the Paris Club was conditioned on securing comparable relief from their bankers and/or bondholders. This was true even when debt to private creditors was small or was not yet falling due, as in the cases of Pakistan and the Dominican Republic. In return for a Paris Club debt rescheduling of payments due in 1999-2000 (along Houston terms), Pakistan was forced to rescheduling three Eurobonds maturing during 1999-2000 even though the amounts involved were relatively small. And in exchange for a Paris Club debt rescheduling of some arrears and payments due in 2004 (along Classic terms), the Dominican Republic was required to reschedule a Eurobond maturing in 2006 and another

[20] See Nouriel Roubini and Brad Setser, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (Washington, DC: IIE, 2004), pp. 30-31 and 149-155.

one falling due in 2013.[21] In other instances, as in those involving the Ukraine in 1998-2000 and Ecuador in 1999-2000, it was the IMF rather than the Paris Club that conditioned its financial assistance to the achievement of debt relief from private creditors. By the time Ukraine and Ecuador came calling on the Paris Club (in July 2001 and September 2000, respectively), the debt restructuring deed had already been done.

Contrary to a common assumption in G7 policymaking and academic circles at the start of the decade – that bondholders were too atomized and disorganized to help a sovereign debtor in distress restructure its debt obligations in a timely manner – the absence of a supranational sovereign bankruptcy mechanism did not delay, never mind impede, several workouts that have taken place in the past decade.[22]

During the period from 1998 until 2003, the governments of Ecuador, Moldova, Pakistan, Russia, Ukraine, and Uruguay were all able to restructure their commercial bank and/or bonded debt – and did so at a progressively faster pace, as issuers and investors became accustomed to the mechanics of bond restructurings. Sovereign debtors obtained meaningful debt-service relief and

[21] The Paris Club would later also agree to reschedule payments due in 2005.
[22] According to the then first deputy managing director of the IMF, and despite growing evidence to the contrary, a new approach to sovereign debt restructuring was needed because "in the current environment, it *may* be particularly difficult to secure high participation from creditors as a group, as individual creditors *may* consider that their best interests would be served by trying to free ride . . . These difficulties *may* be amplified by the prevalence of complex financial instruments . . . which in some cases *may* provide investors with incentives to hold out . . . rather than participating in a restructuring" [emphasis added]. See Anne O. Krueger, *A New Approach to*

even sizable debt forgiveness through the use of exchange offers, often accompanied by bondholder exit consents that encouraged the participation of as many investors as possible in take-it-or-leave-it settlements. Rather than amending bond covenants, the exchange offers typically entailed the debtor government presenting its private creditors with a menu of voluntary options, such as accepting new bonds for a fraction (for example, 60 percent) of the principal owed but paying a market interest rate, or else new bonds for the original principal but paying a concessional interest rate. Experience demonstrated that neither the threat of litigation nor actual cases of litigation derailed these debt relief operations, which involved everyone from large, institutional investors to small, retail bondholders throughout the world.[23]

Sovereign Debt Restructuring (Washington, D.C.: International Monetary Fund, April 2002), p. 8; available at www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf.

Table 1: Comparison of recent restructurings of sovereign bonds

	Argentina 2005	Dominican Republic 2005	Ecuador 2000	Pakistan 1999	Russia 1998-2000	Ukraine 1998-2000	Uruguay 2003
Per capita income ($)*	13,920	7,150	3,363	1,826	6,592	3,841	8,280
Scope ($ billions)	81.8	1.1	6.8	0.6	31.8	3.3	5.4
Number of bonds	152	2	5	3	3	5	65
Jurisdictions involved	8	1	2	1	1	3	6
Months in arrears	41	None	10	2	18	3	None
Minimum participation set	No	No	Yes	Yes	Yes	Yes	Yes
Recognition of interest arrears	Partial	Yes	Yes	Yes	Yes	Yes	N/A
Principal forgiveness	Yes	No	Yes	No	Yes	No	No
'Haircut' on Discount bond (%)	66.3	0	40	0	37.5	0	0
Lowered coupons	Yes	No	No	Yes	No	Yes	No
Extended maturities	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Participation rate (% of eligible)	76	97	97	95	98	95	93

*Note: "N/A" stands for not applicable. *Adjusted for purchasing power; data correspond to year(s) indicated of debt restructuring.*
Source: IIF, IMF, World Bank, author's calculations

Since 2003, there have been four other successful sovereign debt restructurings involving small countries in Central America and the Caribbean: Belize, Dominica, Grenada and Dominican Republic. In the first three instances, commercial banks and bondholders have been prevailed upon to grant substantial debt forgiveness. In another instance of treatment that was anything but comparable, the Paris Club of official creditors has agreed only to a debt rescheduling along Classic terms for Grenada (2006), and has not been called upon to offer any debt relief to Belize or Dominica. In the case of the Dominican Republic, as mentioned previously, the country turned first to the Paris Club and it consented to a debt restructuring along Classic terms (2004-05) – but then the country was obligated to restructure payments to commercial banks and

[23] For additional background information, see IMF, "Cross-Country Experience with Restructuring of Sovereign Debt and Restoring Debt Sustainability," draft, August 29, 2006, available at http://www.imf.org/external/np/pp/eng/2006/082906.pdf.

bondholders. The multilateral agencies, for their part, have provided various degrees of support to these countries. For instance, Dominica and Grenada are sufficiently poor that they qualified for concessional lending from the IMF under its Poverty Reduction and Growth Facility (PRGF); the Dominican Republic has borrowed from the Fund under its normal Stand-by Facility; and Belize has decided to make do without any IMF or World Bank financial support. Belize is therefore an interesting example of a country that is being "bailed out" exclusively by private-sector creditors, since official bilateral and multilateral creditors account for 40 percent of the government's external debt but they have not provided financial support.[24]

A relatively new phenomenon, which also exemplifies the difference in the contribution made by private versus official creditors to the resolution of debt overhang problems, is the prepayment of debt that three governments (Nigeria, Peru and Russia) made to the Paris Club during 2005-06. In the summer of 2005, basking in the glow of their oil bonanza, the Russian authorities decided to make a first prepayment of $15 billion to clear debts to official bilateral creditors, and a year later the country repaid the remainder of its Paris Club debt – $22 billion in cash. In the second half of 2005, the Paris Club also accepted an offer made by the government of Peru to prepay up to $2 billion in maturities of its debt falling due during 2005-09, using the proceeds from financing obtained in the world capital markets.

[24] Some new loans might be forthcoming, however, from two regional development banks. See IMF, "Belize: Staff Report for the 2006 Article IV Consultation," October 5, 2006, pp. 48-53,

In October 2005, the Paris Club reached a long-awaited deal with the government of Nigeria, whereby the country, enjoying (like Russia) a major oil-related windfall, first cleared its payment arrears in exchange for a 33 percent cancellation of eligible debts; and then, in March 2006, paid other amounts coming due in exchange for a further cancellation of 34 percent on eligible debts, with Nigeria buying back remaining obligations. In total, the deal allowed the country to obtain debt cancellation estimated at $18 billion (including past-due interest), representing about 60 percent of its debt to the Paris Club, in return for making cash payments amounting to $12.4 billion.[25] Needless to say, Paris Club creditors did not insist that these three countries should treat their private creditors in a comparable manner, and pre-pay them or otherwise compensate them for debt forgiveness granted in earlier years. As noted earlier, "comparability of treatment" is a highly discretionary, one-way street.

SOME CONTRASTING INDIVIDUAL CASES

The cases of Bolivia, Nicaragua, Ecuador and Argentina, with which this author had some involvement, bring home the difference between how private and official creditors have treated – and have been treated by – governments in serious financial trouble. These developing countries offer an interesting variety

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available at http://www.imf.org/external/pubs/ft/scr/2006/cr06369.pdf.

[25] Paris Club press releases dated June 15, 2005 (Peru), October 20, 2005 (Nigeria) and June 23, 2006 (Russia), available at http://www.clubdeparis.org/en/press_release/page_commupresse.php.

because they span the range of income categories identified by the World Bank and other multilateral agencies: low income (Nicaragua), middle income (Bolivia and Ecuador), and upper income (Argentina).

Bolivia: In 1988, following many years of debt-servicing difficulties, the government of Bolivia retired most of its commercial bank debt through a buyback, with creditors writing down nearly 90 percent of what the government owed them. In 1992, under the aegis of the Brady Plan, the remaining private creditors were given the option to accept a cash buyback incorporating an 84 percent discount; a short-term bond with a similar degree of forgiveness convertible on maturity into local assets at a premium; or else a 30-year, collateralized bond bearing no interest. And a year later, in 1993, the government offered yet another debt buyback, funded by grants from the World Bank's IDA and various donor governments, whereby virtually all remaining commercial creditors tendered their debts and accepted a loss of 84 percent of principal. As a result, Bolivia's government debt to private creditors, which had exceeded $1 billion back in 1980, accounting for half of its external obligations, dropped to less than $75 million by the mid-1990s, equivalent to not even 2 percent of total.[26] Private creditors had accepted huge, upfront losses but at least they were no longer responsible for Bolivia's remaining debt woes.

[26] See various issues of World Bank, *Global Development Finance* (Washington, DC: World Bank, various years).

Bolivia became eligible for debt relief from official bilateral and multilateral creditors under the original HIPC initiative in September 1998, a full decade after private creditors began to forgive their portion of the country's debt. Bolivia obtained less than $30 million in official debt forgiveness in 1998, an amount which increased to almost $90 million per annum in 1999-2001, and subsequently, having qualified under the Enhanced HIPC initiative, to an annual average of about $160 million during 2002-04 – the equivalent of around 1.5 percent of annual GDP. However, despite this steady debt relief, and largely because of growing budgetary deficits as a result of rising government sending, Bolivia's public-sector debt increased from the equivalent of 60 percent of GDP in 2001 to 71 percent of GDP (some $6.7 billion) in 2005. It has dropped since then because of substantially higher oil-related revenues – not because of official debt relief on the installment plan.[27] The country's external debt-service payments, which averaged 4.3 percent of GDP per annum during 2003-05, are expected to average 2.6 percent of GDP during 2006-08 after HIPC and MDRI-related relief.[28]

Nicaragua: In 1995, in a buyback of commercial bank debt funded by grants from the World Bank's IDA and various donor governments, most private creditors forgave 92 percent of what the government of Nicaragua owed them ($1.1 billion). Foreign commercial banks had accounted for more than 15 percent

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[27] See Fundación Jubileo Bolivia, *Romper la Cadena: La Deuda Pública de Bolivia*, 2005, available at http://www.jubileobolivia.org/publicaciones/REVISTA_FINAL_si.pdf; and IMF, "Bolivia: Staff Report for the 2006 Article IV Consultation," June 28, 2006, available at http://www.imf.org/external/pubs/ft/scr/2006/cr06270.pdf.

of the government's external debt, but after this immediate debt forgiveness they represented a mere 3 percent of total. Earlier that year, official bilateral creditors represented by the Paris Club had agreed to cancel up to 67 percent of eligible debts under Naples terms, but the multilateral agencies provided no debt relief – except for the Central American Bank for Economic Integration (CABEI), which at least agreed to reschedule its loans to Nicaragua. The government's external debt consequently dropped from nearly $12 billion in 1994 – by far the highest debt burden among developing countries, equivalent to more than 9 times GDP – to $6 billion by 1996 (a still excessive 375 percent of GDP).[29]

Nicaragua never became eligible for debt relief under the original HIPC initiative, but in the event it reached its completion point under the Enhanced HIPC in January 2004. The government's external debt is presently being reduced from over $7 billion to about $3 billion (representing a high but tolerable 65 percent of GDP) thanks to debt forgiveness by bilateral and multilateral lenders. And yet, its external debt-service payments, which averaged 2 percent of GDP per annum during 2003-05, are expected to remain at that level during 2006-08 despite HIPC and MDRI-related relief.[30] Nicaragua is also having trouble obtaining all of its HIPC relief because it has 23 non-Paris Club official creditors, more than double the average of other HIPC countries, and some of them are refusing to

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[28] Development Committee of the World Bank and IMF, op. cit., p. 66.
[29] See World Bank, *Global Development Finance 2001* (Washington, DC: World Bank, 2001), Volume 2, Table 1, available at http://siteresources.worldbank.org/INTGDF2001/Resources/reg-external-debt.pdf.
[30] Development Committee of the World Bank and IMF, op. cit., p. 67.

grant debt relief (e.g., China, Iran, Libya and Taiwan) – one of them (Libya) has even resorted to litigation, demanding full payment.[31]

Ecuador: In 1995, following many years of debt-servicing difficulties, the government of Ecuador asked private creditors to grant either principal or interest forgiveness as part of a comprehensive Brady Plan restructuring of nearly $8 billion in commercial debt, and also to write off a portion of past-due interest. Most creditors (60 percent) accepted the choice of 30-year Discount bonds with a 45 percent 'haircut' on the principal owed, while the rest acquiesced to 30-year bonds with highly concessional coupons delivering an equivalent amount of relief on an NPV basis.[32] As an immediate result, Ecuador's public external debt was reduced by $1.8 billion, or 17 percent of total.

When Ecuador experienced acute fiscal difficulties again in 1999, the IMF made it clear to the government that it would not get any help from the official community unless it stopped paying its private creditors and obtained debt forgiveness – again. Ecuador thus had the dubious honor of becoming the first country to default on its Brady bonds, and also one of the first (at least in contemporary times) to default on Eurobonds. In mid-2000, the government proposed a complex debt relief operation whereby the various bonds in default were subjected to "haircuts" ranging from 19 percent (Brady Par bonds) to 47 percent (the Eurobond maturing that year) before being exchanged for a mix of

[31] Ibid, p. 25.

new Eurobonds (maturing in 2012 and 2030) and some upfront cash to help cover arrears. The deal as accepted resulted in a cut in the face value of Ecuador's debt stock of 40%, and in cash-flow savings of about $1.5 billion over the first five years. In the wake of this debt relief, obligations to bilateral and multilateral creditors came to account for the majority (60 percent) of the government's remaining external indebtedness.

In sharp contrast, official bilateral and multilateral lenders have never agreed to any debt reduction for Ecuador. The country appealed for debt relief to the Paris Club time and again – in four instances during the 1980s, and also in 1992, 1994, 2000 and 2003 – and while it was deemed to be insolvent enough to deserve write-offs from private creditors on the two occasions noted (1995 and 2000), it was considered insufficiently needy to deserve write-offs from official creditors even once. At the beginning of the 1990s, the Paris Club was owed about $2 billion or one-fifth of Ecuador's public-sector external debt, but it agreed merely to reschedule payments falling due in the short term according to Houston terms – namely, with some reduction in interest payments. The last rescheduling by official bilateral creditors, in mid-2003, involved stretching out a mere $81 million falling due in the year through March 31, 2004.[33] The multilateral agencies, for their part, have neither rescheduled nor reduced any of the country's debt, and they have provided little or no net financing to Ecuador. In fact, from 2001 to

[32] Other shorter-maturity bonds were also issued, for example to cover a portion of past-due interest, and Ecuador paid a small amount of arrears in cash.
[33] See various Paris Club press releases relating to Ecuador available at http://www.clubdeparis.org/en/press_release/page_commupresse.php.

2004, amortization payments by Ecuador's government to official bilateral and multilateral creditors actually exceeded disbursements received from those same creditors.[34]

Argentina: The largest and potentially most complex default the world has ever known was declared by the government of Argentina in December 2001. A punishing, unilateral restructuring offer was presented to bond investors three years later (January 2005), which was later accepted by 76 percent of total bondholders, and the government thereby obtained principal forgiveness estimated at 56% of affected debt and managed to inflict NPV losses of around 75%. Eligible for the massive bond exchange were 152 different securities amounting to a total of $82 billion, including a relatively small amount of past-due interest (accrued through end-2001) – because interest arrears after that point were not recognized. Eleven new securities were offered to participating investors, and they ranged from Par bonds which were not subject to a haircut on nominal principal but paid very little interest and had a final maturity of 35 years, to Discount bonds with a principal reduction of 66 percent and better terms otherwise, designed to meet out approximately equal NPV losses.[35]

Argentina's insistence on such massive debt relief is without precedent in its own checkered financial history, and also in comparison with the debt relief obtained

[34] See IMF, "Ecuador: First Review Under the Standby Arrangement…," July 23, 2003, p. 22, available at http://www.imf.org/external/pubs/ft/scr/2003/cr03248.pdf; and "Ecuador: Staff Report for the 2005 Article IV Consultation," January 4, 2006, p. 34, available at http://www.imf.org/external/pubs/ft/scr/2006/cr0698.pdf.

by other upper-middle-income countries – the likes of Chile, Mexico, South Africa or Turkey – in decades past. It can only be compared with the large-scale relief obtained by much poorer countries such as Bolivia or Nicaragua, as detailed above, or by other HIPCs. To add insult to injury, Argentina's fiscal performance and international reserves, and most economic and social indicators, have fully recovered from their low point in 2001-02.[36] The government has remained current in its obligations to the multilateral lending agencies, even though they have greatly diminished their disbursements to the country. It has also prepaid all of its debt to the IMF: a whopping, $10 billion payment made at the end of 2005, following principal payments of about $13 billion made earlier. And while Argentina has been in default to the bilateral agencies represented by the Paris Club (for about $4.5 billion, including interest arrears, as of mid-2006), all that the government is reportedly expecting is an eventual rescheduling under Classic terms.[37]

Arguably, Argentina's bondholders could have fared much better if official bilateral and multilateral creditors, led by the United States and other G7 governments, had stood up to this rogue sovereign debtor and had insisted on fair treatment for private creditors. Instead, they essentially sided with Argentina, or at best turned a blind eye to its aggressive designs, thereby encouraging the

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[35] See IMF, "Cross-Country Experience…," op. cit., pp. 12, 14 and 48-49.

[36] See IMF, "IMF Executive Board Concludes 2006 Article IV Consultation with Argentina," August 9, 2006, available at http://www.imf.org/external/np/sec/pn/2006/pn0693.htm.

[37] Argentina has already offered to pay the government of Spain the nearly $1 billion it owes on condition that the Spanish government is willing to stretch out the payment through 2012. See Argentina's Clarín newspaper, "Argentina pagará a España toda su deuda antes del 2012," November 5, 2006, available at http://www.clarin.com/diario/2006/11/05/elpais/p-00401.htm.

authorities in Buenos Aires to make mincemeat out of its bondholders. To begin with, the Bank for International Settlements (BIS), the Basle-based central banks' central bank, allowed itself to be used as a safe harbor for Argentina's hard-currency assets, because while on deposit there they are out of attachment range from bondholders who have obtained judgments against the government in various courts. Second, the multilateral lending agencies were actually supportive of Argentina via a series of new loans granted by the IMF, the World Bank and the Inter-American Development Bank, especially during 2003 and the first half of 2004. This despite the fact that the IMF has had a policy of lending to a government in default only when it is pursuing "appropriate policies" *and* when it is making "a good faith effort to reach a collaborative agreement with its creditors."[38]

Argentina also won an important gesture of political support in the form of *amicus curiae* briefs filed by the US government and the Federal Reserve in US courts in January 2004. The government in Buenos Aires succeeded in persuading US authorities that the international payments system was at risk from the potential application of a legal clause (*pari passu*) which had been used by creditors against the governments of Peru and Nicaragua. And then, while Argentina was crafting its request for debt forgiveness (during 2004), the IMF declined to insist upon overwhelming acceptance of whatever debt restructuring proposal the country would put forth to its creditors. Doing so would not have been unusual for

[38] See IMF, "IMF Board Discusses the Good-Faith Criterion under the Fund Policy on Lending into Arrears to Private Creditors," September 24, 2002, available at

the Fund, and it would have put pressure on Buenos Aires to come up with a less punishing proposal, or to have added some last minute “sweeteners” to maximize bondholder acceptance.[39]

CONCLUSION

In sum, institutional and retail bondholders, as well as commercial and investment banks in the United States, Canada, Europe and Japan, should be recognized for their very good track record in dealing with sovereign debt problems. They have helped to resolve expeditiously and even generously – and mostly unconditionally – the multiple cases of sovereign overindebtedness in which they have been involved in various parts of the world. The official development community cannot make a similar claim. Indeed, private creditors have been much more progressive, flexible, and quick in dealing with sovereign insolvency situations than have been official lenders.

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http://www.imf.org/external/np/sec/pn/2002/pn02107.htm.

[39] See Porzecanski, op. cit, pp. 327-331.