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ABSTRACT

Economic theory and evidence from a variety of debt markets shed light on current reform proposals concerning emerging market debt. Debt markets, including the U.S. municipal bond market, generally function best when the rights of creditors are protected most effectively. Since current IMF reform proposals significantly emasculate creditor rights, they are likely to have an adverse effect on the flow of new funds to sovereign borrowers.

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The market for sovereign debt of developing countries is alleged to be gravely ill. In the last five years, several East Asian countries, Russia, Argentina, and other borrowers defaulted on their sovereign bonds. Financial crises in borrower countries, as well as prolonged, messy and litigious debt renegotiations accompanied these defaults. Some see the so-called "rogue creditors," who sue to get their money back and delay settlement, as the culprit of the market's problems (White 2002). To confront them, reformers propose to change debt restructuring procedures by reducing creditor rights. The IMF in particular advocates using some features of U.S. Chapter 11 corporate bankruptcy that are favorable to borrowers in sovereign debt restructuring (Krueger 2002).

This paper uses the experiences with bankruptcy in other debt markets to reexamine sovereign debt restructuring. I argue that the ailment of sovereign debt markets has been mis-diagnosed. Experience shows that debt markets work best when the rights of creditors are protected most effectively. From this perspective, the troubles afflicting sovereign debt markets result from creditor rights being too weak, not too strong.

There is a more evocative way to put this point. As Secretary of the Treasury, Lawrence Summers asked: Why can U.S. municipalities borrow at such low rates, and have such low rates of default, compared to sovereign borrowers? How can the sovereign debt market become more like U.S. municipal bond market, with few defaults and low interest rates? The answer, I believe, is that creditor rights vis-a-vis defaulting U.S. municipalities are much greater than those of lenders vis-a-vis their defaulting sovereign borrowers. As a consequence, defaulting municipalities repay their creditors in full or almost in full, and municipal bond markets function well.

The objective of the paper is to consider how sovereign debt markets can be improved. Some academics believe that the problems of sovereignty doom these markets. Except for very good

borrowers who care about their reputation, the markets should not really exist (Bulow 2002). According to this view, existing debt should be forgiven and replaced with foreign aid. This view may well be correct. Still, in this paper, I focus on the possibility of improving the sovereign debt market rather than writing it off.

I. The Structure of Debt Contracts.

Debt is a contract, in which the borrower accepts some money and agrees to pay it back. If the borrower fails to repay, the creditor acquires certain rights and powers vis-a-vis his assets. Except for some possible reputational concerns, those rights are the main reason that borrowers ever pay back (Hart 1995).

A typical debt contract is collateralized. The lender's most basic power is to seize the collateral of a defaulting borrower. This power supports the mortgage market in the U.S., much of personal lending, as well as standard liquidation-focused bankruptcy procedures in most countries.

For several good economic reasons, grabbing and liquidating collateral can be inefficient. As a consequence, softer bankruptcy procedures have emerged in many debt markets. In the personal debt market, some assets of the borrower are exempt from being seized by the creditors. Likewise, many legal jurisdictions replace liquidation with reorganization, in which a plan for the borrower to pay back the lender is developed under the supervision of a court, averting the seizure of assets.

In the United States, this alternative bankruptcy procedure for corporations is known as Chapter 11. In Chapter 11, the management of a defaulting company has a few months to present the court with a reorganization and repayment plan. During this period, management retains control, creditors cannot grab assets, and the company can borrow fresh capital to continue operations. If the

creditors do not accept the management's plan, they can propose an alternative, which might seek to replace the management or to liquidate the company. Crucially, under the law, the objective of the court is to choose a plan "in the best interest of the creditors."

In many U.S. states, municipalities unlike corporations cannot seek bankruptcy protection from creditors at all. In a few instances, municipalities can seek and have sought such protection, known as Chapter 9. This municipal bankruptcy procedure follows some of the principles of Chapter 11, but further weakens creditor rights. Municipal government is not replaced and the creditors are not allowed to propose competing plans. At the same time, the law continues to clearly specify that any repayment plan must be "in the best interests of the creditors" (McConnell and Picker 1993). In addition, state governments in the U.S. appear to take responsibility for municipal debts, and to intervene aggressively in the fiscal affairs of defaulting municipalities. The work of the Municipal Assistance Corporation in New York City and the assistance to Orange County by the California state government both show that defaulting local governments lose much of their fiscal sovereignty.

The U.S. Chapter 11 bankruptcy -- and relatedly municipal Chapter 9 bankruptcy -- is one of the softest (nicest to debtors) bankruptcy procedures in the world (see, e.g., La Porta et al. 1998). Even the possibility of reorganization, as opposed to liquidation, does not exist in some advanced market economies. Management in the U.S. can unilaterally seek Chapter 11 protection from creditors, whereas in many other countries creditor consent is required to initiate bankruptcy. In the U.S., secured creditors cannot grab assets (there is an automatic stay on assets), which they can do in about half of the developed countries. Perhaps most unusually, in the U.S. management stays after filing for bankruptcy. Consistent with this picture, most studies of the U.S. Chapter 11 bankruptcy see it is as too slow, too soft on the existing management, and often ineffective in setting the company

on the path to economic recovery (Hotchkiss 1995, Kahl 2002a, 2002b).

Yet even in Chapters 11 and 9, creditors have legal rights counterbalancing the softness of the procedure. In Chapter 11, the management makes its proposal under the threat of alternative proposals from creditors that might involve its removal or liquidation of the company. And in evaluating proposals, courts in both Chapters 11 and 9 have a clear obligation to choose one in the best interest of the creditors.

These powers of the creditors are the main reason that borrowers pay back and debt markets exist and prosper. The more the creditors can recover from a defaulting borrower, and the more cheaply they can do so, the more they would lend to begin with, and on more attractive terms.

The sticks in the form of creditor rights are not the only reason why borrowers pay back. There are also carrots that encourage borrowers to settle with creditors. The main carrot in the cases of personal and municipal bankruptcy is the ability to borrow again. For corporations, the benefits of settling with creditors and emerging from bankruptcy include avoidance of liquidation, the ability of managers to keep their jobs and get paid, and the resumption of dividends and unrestricted borrowing. The combination of sticks and carrots allows the various debt markets to function.

II. Creditor Rights and Debt Markets.

In the data, the stronger are creditor rights in the event of a default, the better developed are the debt markets. In the case of personal bankruptcy, creditor rights differ across the U.S. states. Some states have a much larger personal exemption – the assets beyond the reach of creditors in the event of personal bankruptcy – than do others. The available evidence shows that, looking across states, higher exemptions reduce the amount of credit available to low asset households (Gropp,

Scholtz and White 1997), raise the costs and reduce the availability of mortgages (Lin and White 2001), and reduce small firms' access to credit (Berkowitz and White 2002).

La Porta et al. (1997, 1998) examine the relationship between creditor rights and the size of debt markets in 49 countries. They construct an index of creditor rights based on legal rules governing the automatic stay on assets, the respect for seniority of creditors, the restrictions on going into reorganization, and the replacement of management in bankruptcy. The authors present evidence suggesting that countries with stronger creditor rights have larger debt markets (see also Stulz and Williamson 2002). The evidence also shows that greater legal shareholder rights are associated with broader and more valuable equity markets.

The few existing municipal bankruptcies illustrate a similar pattern. Courts expect creditors to be repaid, and generally speaking, they are repaid in full or nearly in full, and with only a short delay. This is done through municipal tax increases, expenditure cuts, as well as assistance from state governments in the form of cash or guarantees of long term bonds. Because they know they have to repay, municipalities borrow moderately, and lenders provide funds at low rates. There is even insurance against municipal default, pointing to the insignificance of moral hazard problems. In light of the evidence, the answer to Summers' question is straightforward: the municipal bond market in the U.S. functions so well, with low spreads and few defaults, because creditors' rights are sufficient to get paid in full after a default.

III. Sovereign Debt Markets.

Sovereign debt markets could not be more different. Some countries borrow massively – often to the point where both they and the lenders know they cannot pay back – and at interest rates

that reflect the high likelihood of default. They default with some regularity, and when they do, often pay back a fraction of what they have borrowed, even when they have the ability to pay, as was the case in Russia in 1998. Debt renegotiation takes years, and is accompanied by massive litigation. In short, in this market, unlike in the municipal bond market, over-borrowing, default and limited repayment are completely normal and expected by both borrowers and lenders.

As Bulow and Rogoff (1989a, 1989b) showed in now-classic papers, this is exactly what one would expect in a market where lenders have no power. Because the borrowers in sovereign debt markets are, well, sovereign, creditors have virtually no rights. Creditors cannot grab assets in the country – the most they can do is to seize a few airplanes or barges of oil, which does not get them far except as a strategy of harassment. Management (i.e., government) is not replaced. Countries default unilaterally, without the consent of creditors. Last but not least, there are no courts with authority over sovereign states whose mandate is to protect the interest of creditors. Bulow and Rogoff conclude by suggesting that there is no good reason why the sovereign debt market exists.

The situation is not quite this dire, since at least some sticks and carrots are available. One power of the creditors, recognized by Bulow and Rogoff, is to disrupt and litigate, since sovereign debt contracts are signed under international law. As importantly, sovereign borrowers settle with their creditors because they want to borrow again, and run the risk that the fresh loans are seized by the old creditors unless there is a settlement. Under the current system, sovereigns in default continue some borrowing from the IMF and in local markets under domestic law. To resume borrowing in international markets, sovereigns settle with creditors and pay them more than zero. Indeed, local financial markets interpret settlement with creditors as very good news (Arslanalp and Henry 2002).

The development community is quite unhappy with the status quo, and in particular with the

litigation and disruption surrounding sovereign default. Such litigation delays settlement, possibly prolonging recessions and raising the cost of IMF programs. There is also a concern that the payment to creditors is in part subsidized by the IMF loans, which puts political and economic pressure on the Fund to demand that burdens be shared.

In making reform proposals, the IMF has two admirable objectives. The first is for sovereign states to be able to borrow at low rates in private international markets to finance their development. The second is for sovereign states not to pay their creditors back, especially during the times of economic distress. The tension between these objectives explains the challenges of reform.

The current proposals focus – at least superficially – on making sovereign bankruptcy more like the U.S. Chapter 11. There are three key elements of the current IMF proposal. The first is collective action clauses in debt renegotiations, the purpose of which is to make it more difficult for "rogue" or "maverick" creditors to opt out of proposed settlement agreements and litigate. The IMF indeed argues that the goal of its proposals is to limit the rights of these minority creditors, rather than of all creditors. The second feature is the creation of a sovereign bankruptcy court, which at the time of the initial proposal was intended to be the IMF itself, but is now envisaged as an independent agency. Third, in parallel to U.S. Chapter 11, the sovereign in default will be allowed to borrow in arrears so that its economy is not disrupted, and the new debt will be senior to the existing debt.

In the discussions of the IMF proposals, collective action clauses have received by far the most attention. Roubini (2002) explains persuasively why the problem of "rogue creditors" is vastly overstated. Lenders are already under tremendous pressure to settle with sovereign borrowers, since any lender who does not agree to a proposed debt exchange or other settlement risks receiving nothing. Collective action clauses increase the pressure to settle on the borrower's terms. Litigation

is one of the few – relatively weak – powers the lenders have if they do not like these terms. Indeed, many of the recent settlements – unlike those for municipal debt in the U.S. – take place on terms highly favorable to the borrowers. This is wonderful ex post for countries in financial crisis, but unlikely to be conducive to the long term health of the sovereign debt market.

The creation of a bankruptcy court can be a very beneficial development for the sovereign debt market if, like the courts in U.S. municipal bankruptcy, the objective of settlement is to best serve the interests of creditors. Of course, the objective of the IMF – again admirable ex post but incompatible with long term health of the market – is exactly the opposite. It wants the court to protect the country from creditors rather than to serve their interests.

But perhaps the crucial – and most neglected – feature of the IMF proposal is a radical increase of lending into arrears. The development objective here is clear and laudable: such borrowing can finance exports and deficit spending and thereby relieve economic hardship. But basic logic, as well as the evidence discussed in the previous section, suggest that this reform is likely to damage the market by eliminating the crucial carrot that allows recovery by creditors. If the country can borrow fresh funds without repaying old debt, it has no incentive to pay creditors anything, and in fact has every reason to remain in "sovereign bankruptcy" forever. The crucial features of U.S. Chapter 11 which counterbalance borrowing in arrears – the threats of liquidation or of acceptance of the creditors' reorganization plan by the judge – do not exist for sovereign debt. Without these threats, and with the possibility of continued borrowing senior to the old loans, there is no reason to repay. And with no reason to repay, there is no sovereign debt market in the long run.

In summary, all the proposals by the IMF share a common element: they reduce creditor rights. These ideas serve the admirable goal of reducing the burden of default on debtor countries.

Yet, by cherry-picking the features of Chapter 11 most favorable to creditors, these proposals ignore the delicate balance between debtor protections and creditor rights that exists in both Chapter 11 and Chapter 9. As all the evidence indicates, enhancing borrower rights while emasculating creditor rights is unlikely to promote the health of emerging debt markets.

IV. Alternatives.

Sovereign debt markets are likely to shrink if the IMF's proposals are adopted, at least for developing countries. Indeed, governments of several significant emerging market borrowers oppose these proposals, precisely because they recognize the consequences of weakening creditor rights for their ability to borrow in the future. Still, there may well exist good strategies for reform. Such strategies must look at successful institutions in their entirety, including both debtor protections and creditor rights.

Traditional collateralized lending, supported by the creditors' right to seize collateral, can probably be expanded even in emerging markets. Countries can pledge their natural resource export revenues, for example, especially when there is no practical way to stop production and export. Mexico successfully pledged a portion of its oil revenues to the United States during the 1995 rescue, and there is no reason why this experience could not become more common.

Relatedly, the IMF could encourage sovereign issuance of securities whose returns are linked to commodity prices or economic performance. Such equity-like securities would require lower payment during economic hardship, and higher payments in times of prosperity. They would avoid many of the problems of self-fulfilling crises that the IMF is concerned with.

But suppose that the reformers wish to pursue bankruptcy procedures similar to Chapter 9 or 11, the concern about the softness of these procedures notwithstanding. These reforms could include collective action clauses and lending into arrears. However, if they do, they could only work if counterbalanced by other features of Chapters 9 and 11. The most crucial of these is the presence of a court with power to enforce its decisions and a duty to find solutions that best serve the interests of creditors. To be effective, such a court must stay away from pursuing development objectives. It should also have jurisdiction over both sovereign borrowers and their lenders, including the IMF.

If the analogy to Chapter 11 is taken seriously, creditors should also be able to present to the court restructuring plans that compete with the proposals of the borrowers (perhaps going second). As long as these proposals are feasible, they should be considered by the court, which should select and enforce the plan "in the best interest of the creditors." Likewise, if the development community wishes to imitate the success of the U.S. municipal bond market by pursuing a procedure like Chapter 9, mechanisms of takeover of national finances by an international authority must be considered. Caballero and Dornbusch (2002) make precisely such a proposal for Argentina.

In the end, a supra-national bankruptcy court may or may not be feasible. But such a court is essential if sovereign default and bankruptcy are to proceed as smoothly as the IMF wants. The success of the municipal bond market in the U.S. suggests that a bankruptcy procedure for a government can work well. But the foundation of such a procedure is the existence of a credible arbiter whose mandate is to protect creditor rights. Without exception, the powers of such an arbiter in every kind of bankruptcy entail some loss of sovereignty by the borrower. Without such an arbiter, however, the loose analogies to Chapter 11 lose credibility. It would be better to leave the market alone. Despite all the turmoil, it has delivered vast amounts of private capital to the developing world.

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